The Real Estate Economy and the Design of Russian Housing Reforms, Part I

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Summary. The transition from plan to market in socialist economies dominates the economic agenda of this decade. This two-part paper on the Russian housing reforms addresses four questions. First, what is the legacy of the administrative-command system and why were demands for major reforms so widespread in the housing sector? Secondly, in what manner does the severe contraction of the Russian economy complicate the reformers' task? Thirdly, how has the Russian government responded so far to the reform challenge? Fourthly, why are the privatisation of housing and rent reforms at the core of the transition to market? The first part of the paper deals with the first two questions. The second part addresses the last two questions. Priority goes to an integrated perspective on the early stages of Russian reforms over an in-depth analysis of individual issues. The modern analysis of the real estate economy distinguishes two markets: the 'property market' for the allocation of space, and the 'asset market' where investment decisions are made. This theoretical insight provides a much needed framework to understand how the key components of Russian reform interact during the housing transition to market.

Introduction

The transition from plan to market in socialist economies dominates the policy agenda of the decade. In no other sector of the economy is support to major reform as widespread and longstanding as for housing, particularly in Russia. However, moving from a state-run, administrative command system to a decentralised, market-based system where households make the key decisions is an extremely difficult task. The design of viable transition policies demands totally new skills from Russian analysts, policy-makers and managers. Under central planning, Soviet housing was not considered as a major economic...
sector, as in Western economies, but merely as a social obligation to be met by administrative organisations, state enterprises or municipal governments. The need for serious scientific analysis of the structure, behaviour and performance of the housing system was not felt, and administrations restricted access to information. The analytical level of understanding of socialist housing in Russia—in contrast with bureaucratic self-justification—was considerably behind Hungary where experiments in ‘market socialism’ and housing reforms had been taking place for over a decade (see Daniel and Partos, 1989). After 1985, with glasnost and perestroika the first Russian attempts at empirical investigation and serious conceptual work took place (see Kalinina, 1986, 1990, 1991; Bessonova, 1988, 1990a, 1990b, 1990c; Kosareva et al., 1990). However, both quality of information and analytical tools were considered inadequate to the needs of reform. Leading Russian economists were very concerned with the severe shortcomings of “the statistics of perestroika and the perestroika of statistics” (see for instance Faltsman, 1989; Treml, 1988; and Yasin, 1989). The problems are particularly severe for housing since it was not even treated as a separate economic sector, and even more so for the ‘real estate economy’ as a whole since the concept itself and its legal implementation did not even exist in the Soviet system.

Why is the transition to market a necessity and not really a choice for housing reforms in Russia in particular? The answers rest in the unique characteristics of housing as an economic good which Marxist analysts like to call ‘commodity housing’, as much as in the terminal shortcomings of administrative-command systems (Renaud, 1991b). Housing is not a very complex technical good to produce in an industrial society. However, it is perhaps the most complex economic good to analyse and manage properly. The durability of housing units is measured in decades. They are quite heterogeneous in terms of design, building technology, age and available utilities. Their value is also linked to the ecological quality, social services and infrastructure of the neighbourhood where they are located. A fourth major feature of housing is its extensive financial, fiscal and physical regulation by government. These characteristics of housing explain why indirect policy instruments operating in decentralised, locally regulated housing markets work much better than direct, centralised interventions by the state in raising the efficiency of the sector, and meeting the needs and preferences of the population. There are macroeconomic reasons as well. The system of state financing usually creates allocation distortions, deadweight losses and destabilising subsidies (see Shironin, 1990). Severe macroeconomic distortions and rapidly growing subsidies also set Chinese authorities on the path of housing reform (see Gao, 1988; Renaud, 1990; and Wang, 1991).

The problems of transforming the housing sector of socialist economies from an administrative-command system into a market-based system are extremely wide ranging. The objectives of this paper are to present the economic dimensions of housing reforms in Russia and to show that there is a core analytical framework underlying the transition by addressing four questions. First, what is the legacy of the administrative-command system in Russia? Here we will compare the performance of the Soviet housing system with that of other socialist housing systems by relying on key indicators. Incidentally, such comparison will highlight the main generic features of socialist housing problems. The second question is what is the impact of the brutal contraction of the centrally planned economy on the administrative-command system and on housing condition? How are current economic conditions in Russia and the difficulty of achieving macroeconomic stability affecting the old Soviet housing system and the newly emerging market segments? Answers to these two questions form Part I of this paper.

Part II covers the remaining two questions. The third one is what has been the Russian government response so far to the challenge of housing reform? In that context, the paper identifies ten key areas where central and
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local reformers have been acting or must act on the road toward sound housing markets. Fourthly, why are privatisation and rent reform at the core of the transition to markets? At present, the Russian housing system remains caught between plan and market. Why is it so important that reformers gain a basic understanding of the fundamental flow of funds through the real estate economy? The modern theory of the real estate economy distinguishes between two fundamental markets: the ‘property market’ where existing real estate space is allocated and the ‘asset market’ where decisions to invest in new construction are made in competition with other uses of the resources available in the economy. The paper closes by showing how this modern theory of the real estate economy permits an interpretation of the severe shocks to which the Russian housing system is presently subjected. It can also describe the core structure of housing reforms during the transition to markets and the intended effects of the main components reforms. As such, this paper aims to provide a benchmark to which more detailed analyses of specific components of the Russian housing reforms can be added and linked.

1. Legacy of the Administrative-command System

The comprehensive scope of the housing reforms now initiated in the Russian Federation cannot be fully understood without knowing the legacy of the administrative-command system used to manage the former Soviet economy, including housing and urban development. This legacy is an extremely distorted and rigid housing system compared to market economies. The most important of these distortions are: one of the highest rates of state ownership in the world; trivial rents charged to users and poor maintenance by state organisations; the overwhelming dominance of state financing in new construction; strong state monopolies over production leading to barren uniformity and low quality of the housing stock from which flow mediocre to poor housing services; last but not least, the absence of land markets has had large and durable negative effects on the structure of Soviet cities. Today, Russia still has one of the most distorted housing systems anywhere, even among socialist economies (IMF et al., 1991; Renaud, 1992).

Housing conditions in the Russian Federation explain why there has been much earlier and much broader public consensus about housing privatisation than about any other sector of the economy. There is now a multiplicity of compelling reasons for making housing reforms and privatisation a very high national economic priority: the large and direct impact of subsidy pressures on central and local government; the severe constraints on labour mobility and employment location linked to the system of state allocation and very long waiting lists; the inappropriate economic burden which housing places on enterprises; and the inefficient internal operation of Russian cities caused by the structure and location of the housing stock.

Because Russia is fully urbanised and not an underdeveloped economy undergoing urbanisation, privatisation implies the transfer of real estate assets to new owners on an extraordinarily massive scale. The benefits of a successful privatisation for the well-being of the national economy will be commensurate. A flexible housing system responsive to local conditions will need effective local governments. Because the housing system has been heavily centralised, local governments have had great difficulties in managing urban affairs against strong sectoral administrations. They have emerged from the Soviet era in weak condition to manage privatisation and the emergence of market cities, in addition to an unanticipated load of new social responsibilities.

Overwhelming Dominance of Public Ownership of Housing

Russia has the most distorted urban ownership structure among the main socialist countries. In 1989, 83 per cent of the housing
Table 1. Public ownership of housing, c. 1989

<table>
<thead>
<tr>
<th>Country</th>
<th>Public ownership (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Former Soviet Union</td>
<td>78</td>
</tr>
<tr>
<td>China</td>
<td>67</td>
</tr>
<tr>
<td>Poland</td>
<td>56</td>
</tr>
<tr>
<td>Sweden</td>
<td>38</td>
</tr>
<tr>
<td>Romania</td>
<td>33</td>
</tr>
<tr>
<td>UK</td>
<td>30</td>
</tr>
<tr>
<td>Hungary</td>
<td>25</td>
</tr>
<tr>
<td>France</td>
<td>17</td>
</tr>
<tr>
<td>US</td>
<td>2</td>
</tr>
</tbody>
</table>


stock was under state control in Russian cities, by comparison with 67 per cent in China, 56 per cent in Poland, 33 per cent in Romania and 25 per cent in Hungary (see Table 1). Cities like Moscow and St Petersburg had almost 100 per cent of housing in public ownership in 1990. Western shares of public housing are found at the opposite end of the ownership spectrum. In January 1991, the composition of urban housing in Russia was: departmental (enterprise and administration) housing: 46 per cent; local governments: 32 per cent; cooperatives: 6 per cent; individual housing: 16 per cent. Enterprise housing has often proved significantly more costly to operate than municipal housing. Its quality is much more heterogeneous and sometimes in a worse state of disrepair than municipal housing.

Strong Socialist Tenancy Rights

Under the Soviet regime, land and buildings were under public ownership. Yet tenant rights under Soviet housing law were so broad—including lifetime occupancy right, rights to inherit and near-impossibility of eviction—that household incentives to participate in an emerging real estate market are thereby seriously diminished. Moreover, tenants’ rights were often vague and federal authority to act was unclear. Until now, rents paid by households cover such a small fraction of operations and maintenance, utilities are so heavily subsidised and state-built housing has been so heavily favoured in terms of amenities, that being a state tenant has been economically much more attractive than being an individual owner who bears all maintenance costs. At the beginning of reforms, individual housing in Russia carried the unusual connotation of slum housing.

Trivial Rents and Extremely Low-cost Recovery from Occupants

The Russian Federation also has some of the most—if not the most—distorted rents and housing prices in the world. A conspicuous feature of the Russian housing system is that the basic rent charged to households had been frozen between 1927 and 1992 at 0.132 roubles per sq m of living space. In late 1990, before high inflation, a full-cost recovery rent for operations and maintenance (O&M) including capital recovery should have been about Rbs 15 per sq m. However, deferred maintenance once a building is delivered is the de facto policy. No capital cost recovery enters into the rent at all. New buildings are financed on a cash basis from other budget sources. Then they are simply transferred to housing administrations ZhEKs. In practice, the resources actually devoted to O&M by ZhEKs were Rbs 4.5 sq m and covered about 70 per cent of full O&M requirements. Local housing administrations achieved recovery and financial balance approximately in the following proportions: 3 per cent from residents; 78 per
Rent to income ratios in socialist countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Rent only (%)</th>
<th>Utility only (%)</th>
<th>Total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>1988</td>
<td>7.6</td>
<td>4.5</td>
<td>12.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>1987</td>
<td>1.6</td>
<td>7.1</td>
<td>8.7</td>
</tr>
<tr>
<td>Poland</td>
<td>1986</td>
<td>2.0</td>
<td>2.4</td>
<td>4.4</td>
</tr>
<tr>
<td>Romania</td>
<td>1989</td>
<td>3.0</td>
<td>1.0</td>
<td>4.0</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>1988</td>
<td>2.8</td>
<td>6.5</td>
<td>9.3</td>
</tr>
<tr>
<td>USSR</td>
<td>1989</td>
<td>1.0</td>
<td>1.5</td>
<td>2.5</td>
</tr>
</tbody>
</table>


Utility rates charged to residents were heavily subsidised at rates of 80–90 per cent. Total housing payments for a 50m apartment were Rbs 16.0/month in 1991. On-budget subsidies for utilities (electricity, gas and district heating) represented about 5 per cent of GNP in 1990. However, in 1990, Russian domestic oil prices were 6 per cent and coal prices were 8.5 per cent of world prices. Adjusted to world prices and market exchange rates, such utility subsidies to households become extraordinarily large as a notional share of GNP (60 per cent or more). Russian households devoted only 2.4 per cent of cash income to total housing payments (rents plus utilities) but over 3 per cent to liquor and cigarettes (see Table 2). The only exception were cooperative residents (6 per cent of the urban stock) whose effort ranges between 10 per cent and 20 per cent of income, yet these households have incomes comparable to municipal housing residents. Very high levels of inflation since 1991 have further distorted the situation as price changes are not fully passed on to households. (see Table 3).

Quasi Total Financing of Housing Construction from State Sources

Three features of the Russian financing system are important. First the overwhelming share of housing investment funds has always come from the state under the central planning process. Secondly, enterprise funds played no role in financing housing until the enterprise reforms of 1987 which gave more leeway to enterprises in using their investment funds for housing. By 1992, however, departmental funds had become dominant in state funding. Thirdly, the direct contribution of the population has always been and remains very low. Raising the population’s share of funding is a priority objective of the government housing reform programme of 1993. The system of housing cooperatives was revived in the mid 1980s in order to mobilise more funds from the population on waiting lists without altering state monopolies on construction. However, this bureaucratically driven reform was overtaken by the Gaidar shock therapy of 1992. Until 1985, the production of new individual housing was illegal in cities with over 100 000 residents. The dachas on which many Russian families lavish so much care and energy are regulated as seasonal residences only. Their year-round use is also prevented by a frequent lack of utilities, no social services and poor access to work (see Table 4).
Table 3. Household income and expenditures in Russia

<table>
<thead>
<tr>
<th></th>
<th>1991</th>
<th>1992 half year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income (roubles/person)</td>
<td>4262</td>
<td>9546</td>
</tr>
<tr>
<td>Expenditures (roubles/person)</td>
<td>3989</td>
<td>8605</td>
</tr>
</tbody>
</table>

Expenditure (percentage)

<table>
<thead>
<tr>
<th></th>
<th>1991</th>
<th>1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>32.8</td>
<td>41.5</td>
</tr>
<tr>
<td>Alcoholic beverages</td>
<td>3.6</td>
<td>3.7</td>
</tr>
<tr>
<td>Durable/non-durable goods</td>
<td>41.2</td>
<td>32.6</td>
</tr>
<tr>
<td>Taxes</td>
<td>7.0</td>
<td>8.1</td>
</tr>
<tr>
<td>Housing</td>
<td>1.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Other</td>
<td>14.0</td>
<td>11.6</td>
</tr>
</tbody>
</table>

Housing expenditure (percentage)

<table>
<thead>
<tr>
<th></th>
<th>1991</th>
<th>1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>31.4</td>
<td>17.8</td>
</tr>
<tr>
<td>Utilities</td>
<td>68.6</td>
<td>82.2</td>
</tr>
</tbody>
</table>

Source: Goskomstat, Survey of Households (periodical).

State Monopolies in the Building Industry and in Housing Maintenance

It is a truism of urban development that cities are built the way they are financed. Under the administrative-command system, state monopoly over financing, reinforced by state monopolies over land and over access to building materials has led to a highly monopolistic construction industry in every urban region. Housing finance does not exist in the market sense of banking services. It is, instead, mixed with government budgets and state-enterprise budgets. Construction organisations have had no reason to differentiate between housing finance—i.e. banking loans to be repaid at competitive market rates—and housing subsidies—i.e. fiscal grants originating from the state. Up to 85 per cent of new housing construction is financed directly from the budget or by state enterprises, but these budgets are now being drastically cut. To make matters worse, state monopoly over local production became a managerial goal in the early 1980s under the concept of ‘one client, one designer, one builder’ across the 150 largest cities. Such a managerial goal demonstrates a fundamental misunderstanding of the efficiency and innovation benefits of contracting and sub-contracting in the construction industry (see Renaud and Czerny, 1992; and World Bank, 1994. ch. 8). However, this goal was never reached due to contemporaneous shifts in sources of funds away from central government to enterprises.

The housing product itself consists primarily of high-rise apartment blocks of heavy, reinforced-concrete, large panels. This assembly-line housing technology is not liked by most occupants. It is of low quality and high cost, and is energy-inefficient compared to other known technologies, yet it constitutes now over 60 per cent of the national stock. Alternative technologies, designs, skills and materials have been neglected. The rate of innovation has been extremely low in Russia and has often been blocked by building regulations. The incentive structure to construction organisations rewards them on the basis of square metres produced, not quality. Deferred maintenance is an endemic feature of the system. Once a building has been delivered to its intended owner, repair and rehabilitation of the existing stock are often seriously neglected. O&M costs per sq m are much higher than in market economies due to poor design, frequently poor construction and always poor finishing—as well as the absence of utility metering at the apartment unit and building levels. The central concept of lifetime costing of buildings is
alien to this bureaucratic decision-making environment where the end-user has no voice.

**Long Russian Tradition of Limited Private Property Rights**

Certain aspects of housing policy in Russia have shown a remarkable amount of continuity over the past several hundred years. In particular, Russia has never had a strongly developed notion of individual land ownership. The second decree passed by the new revolutionary government in October 1917 abolished the private ownership of land. Before the year 1917 was over, all large residential buildings in cities had been nationalised. Also, Russia has long limited freedom of movement and settlement with institutions ranging from serfdom in medieval times to the *propiska* residency permit system (World Bank, 1994, vol. 2, Annex 2).

At the time of the 1917 revolution, Russia was the least urbanised and most backward European economy with a level of urbanised population of only 16 per cent. Today Russia’s urbanisation is essentially completed and its system of cities has developed without any reference to private individual property, market mechanisms or private financing—and without the institutions associated with them. Instead due to the administrative-command nature of central planning most land-use laws and regulations tend to have a narrow and *ad hoc* sectoral focus. The legal continuity of real estate property rights through a wide variety of rural and urban uses and recycling is a new perspective in the Russian Federation.

**Absence of Land Markets and Negative Results for Soviet Cities**

Except for the old historical city centres, almost all of Russian urban growth has taken place during the Soviet socialist era, 1917–91. All the urban investment which was necessary to build the Russian urban system was based on three major price distortions: site value was not priced; capital had no interest; and energy prices were a small fraction of world prices. The resulting socialist cities have a structure that is strikingly different from market cities. The fact that urban development took place in a period when land was nationalised and administratively allocated rather than sold on an open market for a price has had a very profound impact on the internal organisation of Russian cities (Bertaud and Renaud, 1994). The Russian administrative-command economy has generated an urban development process with two characteristic features of large land-use inefficiencies: areas with obsolete land use occupy large amounts of prime land in the total city area creating a barren industrial city core; and households tend to be concentrated in the periphery with increasing densities further from the centre and ‘historically’ low densities in central areas. Yet, the location of jobs remains very centralised compared with market cities.

This urban land-use pattern increases transport costs and pollution by requiring higher energy expenditure without providing better amenities such as larger plot size or a better environment that would be the normal trade-off for increasing commuting distance in a market economy. High-density residential areas surround these old polluting industrial cores acting like a containment barrier, thereby increasing environmental risks to residents. As the Russian economy finally shifts to world prices, transport costs will also shift. The result will be a temporarily negative asset value for significant sections of residential suburbs until residential choices and employment location have shifted on a scale large enough to reflect the true economic cost of access to various parts of Russian cities.

The failure to recycle land occupied by old activities of little value—this ‘fallow land’ syndrome—yields several spatial outcomes: centrally located industrial belts, large total amount of urban industrial area, low job density in the industrial belts, and central land areas fragmented by dense railway networks. Of these pathologies, the most startling are the old industrial belts that ring
Moscow and St Petersburg. Developed during the 1930s and 1950s, these belts are still spread 4–8 km from the city centres. These industrial land-use bottlenecks have never been recycled, even though the land values would have been prohibitively expensive for the enterprises still found there, had market land prices been used. The absence of market signals and economic incentives has resulted in a land-use freeze that pushed residential areas further toward the city periphery than in market cities. Meanwhile, obsolete and low-density activities have remained as enclaves on accessible and well serviced land. The magnitude of the land misallocation problem in Russia has nothing in common with land leapfrogging in market economies. The scale in Russia is massive. For instance, in Moscow 31.5 per cent of the total built-up area is used by industries compared with 5 per cent in the Paris metropolitan region which has a comparable population. In Moscow, within a prime belt located 7–8 km from the centre, 64 per cent of the land is used by industry. This is an extraordinary ratio for a capital city (Bertaud and Renaud, 1994).

The impact of socialist urban investment on the housing stock is that there is a very clear possibility that large sections of Russian cities have a negative asset value under realistic pricing aligned on world market conditions. The rents that can be received from these units are lower than their operating costs. Occupants of some suburban housing are now jointly faced with sharply escalating operations and maintenance costs, as well as rapidly rising transport costs. Yet, the housing they occupy is identical in size and amenities to that found in much better locations. In 1992, rents were increased but by trivial amounts: a typical rent was Rbs 1.8 per sq m per month but new O&M costs were Rbs 80.0 per sq m per month, leaving aside capital costs as sunk costs or consideration of replacement costs. A similar pattern of nominal rents lagging behind operating costs and monthly inflation prevailed in 1993 and 1994. This is to be expected under monthly inflation rates fluctuating around 7–15 per cent per month.

Russia as a Fully Urbanised Economy and the Implications

A distinguishing feature of Russian housing is that public ownership and the administrative-command system have been operating in full force precisely during the decades when Russia was becoming fully urbanised. This completed urbanisation now has two main consequences, compared to the case of developing socialist economies. First, the possibility of further urbanisation under market conditions no longer exists. Population mobility across urban areas is predominantly a zero-sum game, like in many advanced market economies. Russia faces a complex mix of growing and declining cities. With a very slow growth of the overall urban population, opportunities to expand the urban physical plant in every city under new and more efficient market mechanisms are rather limited. Secondly, the share of urban assets in the national economy is very large and at least 20 per cent of total reproducible assets. Hence the urgency of an economically sound restructuring of this wealth.

The dominant Russian task will be to restructure the existing urban stock. In January 1992, 74 per cent of Russia’s population of 148.8m lived in cities. During the post-war period the Soviet Union experienced the highest rate of urbanisation among the nine main UN demographic regions of the world. As a result, a high proportion of the housing stock is of recent vintage compared to European or US cities. However, this urban growth was distributed differently from that of market economies. Russia has a relatively lower degree of urban concentration in large cities and a low share of population living in cities of over 1m people. The period of economic and political adjustment which Russia is now undergoing will cause significant flows of migration. Some residual rural–urban migration can also be expected if agricultural productivity increases to Western
levels. City-to-city migration will dominate, but the emergence of sustainable new towns is not likely to be significant. Therefore, most housing and urban investment efforts during the 1990s should be directed to raising the international competitive capacity of existing Russian cities. There is considerable Russian interest in using population control and distribution policies to favour small-town development, and in particular to repopulate Central Russia. This interest is motivated by deep environmental concerns. However, such population decentralisation policies could have a very high up-front capital cost. They would be economically inefficient and usually inconsistent with economic recovery, free mobility and effective employment generation.

Potential Magnitude of Real Estate Asset Transfers under Privatisation

Until the economic liberalisation of early 1992 which dissipated the monetary overhang, a glaring problem of the Soviet housing system was its large-scale asset misallocation and the consequent loss of efficiency. The state owned most of the physical assets and the households had the liquidities and financial savings. Households accumulated savings which they could not use to buy housing, while the state could not organise well enough to produce attractive units in adequate quantities. In 1990, the value of capital assets controlled by house- holds was trivial. Household wealth was only 3.6 per cent of total net reproducible assets in the economy. Household balance-sheets in the market economies of Western countries are totally different. Housing assets are a greater share of national wealth, almost all of it is privately owned, mostly by individuals (Table 5). The share of housing in the national wealth of socialist economies in transition (TSEs) is lower than in market economies at a similar level of development. This is due to the depressed value of the stock caused by public policies prohibiting trade and the social and private gains benefit associated with it—housing privatisation entails a potentially very massive transfer of assets. In addition to its massive scale, this housing stock to be privatised is characterised by its uniformity, its recent vintage and its low construction quality and poor maintenance.

The Weak Condition of Local Governments at the End of the Soviet Era

Good market-based housing systems require sound national laws and central-level policies on regulations and finance. However, to operate well on a day-to-day basis, housing markets are dependent on strong and well managed local governments. In the largest and most diverse country in the world, the success of housing policy rests on local
governments provided with a sound national policy framework, adequate autonomy and resources. Not all Soviet cities operated by the powerful standards of Moscow or St Petersburg which are autonomous cities with the status of oblast (region). For both technical and political reasons, city governments under the Soviet socialist regime have often been weak, lacking administrative autonomy and significant financial resources. With the dominance of central-level and sectoral planning over local and spatial planning, cities always had inadequate resources and limited power to control their own decisions. The local Soviets and their executive committees (ispolkom) were the designated decision-making bodies in their area of jurisdiction. However, the principle of dual coordination made all local departments responsible both to the Soviet at their level and to the corresponding line organisations at the next highest level. As a result, in case of conflicts Oblast-level governments and line ministries usually prevailed over local preferences and better knowledge of local conditions.

2. Current Conditions in the Housing Sector

A Difficult Stabilisation and Reform Phase

The Russian economy has now entered a difficult phase of its stabilisation and reform programme which has a strong negative impact on the short-term performance of the housing sector. Current domestic monetary policies and inter-state trading conditions are making economic liberalisation and price stabilisation more uncertain. They are affecting privatisation options in all sectors of the Russian economy, including housing and construction. However, these unstable economic conditions must be faced. They do not invalidate the general market orientation of reforms. In fact, it is delays in economic reforms during the 1980s that have made reforms today more difficult. Therefore market-oriented housing reforms must be initiated as part of the return to stability. A reform-based revival of the housing sector can contribute both to economic recovery and to the modernisation of the sector itself.

Strong Impact of the Economic Crisis on the Housing Sector

The impact of economic contraction and very high inflation has been particularly severe on housing which is one of the longest-lived goods in the economy. National output has been contracting sharply for several years: GDP declined by about −5 per cent in 1990, −9 per cent in 1991, −20 per cent in 1992, and by about −11 per cent in 1993. Inflation has been bordering on hyperinflation with a rate of 2480 per cent in 1992. Since then, monthly inflation has been fluctuating between 5 and 20 per cent. This economic crisis has been unfolding in stages since the early years of Perestroika in 1985. The housing crisis itself has several dimensions. The composition of funding for new construction is changing very rapidly. New housing production has dropped dramatically. Inflation-adjusted household incomes have fallen sharply while construction costs have risen sharply, making housing affordability even more problematic. Due to inflation and deep cuts in central subsidies, resources for housing maintenance have shrunk abruptly. Faced with the prospects of rapidly rising expenditures on operation and maintenance of the municipal stock, local governments are deferring almost all maintenance. With this generalisation of deferred maintenance, particularly since early 1992, the housing stock is depreciating at a high rate, most likely at considerably more than 3 per cent per year. The precipitous fall in new construction is combining with generalised deferred maintenance to produce a rapid contraction of the total supply of housing services, and a worsening of housing conditions.

Major Changes in the Flow of Funds through the Housing System

Rapid changes are restructuring the flow of funds through the traditional Russian housing system. Some of these changes reflect early
reforms of the administrative-command system. Other more recent short-term measures have been imposed by the economic crisis. Now more decisions are aimed at forward-looking reforms. All are modifying the behaviour of the housing system in lasting ways. There are four main types of changes:

(1) the reduction of the share of central budget financing in state funding;
(2) the sharp contraction in overall state funding of new production;
(3) the large cuts in subsidies to housing maintenance and the rising burdens of local governments; and
(4) the emergence of (state or private) employers as the dominant source of financing for new housing.

This new dominant role of employers is reinforced by the sharp fall in real household incomes and the deteriorating household income distribution.

Shift Away from Direct Budget Funding and Decentralisation of Financing

The financing of new housing construction began to change in the mid 1980s. The main component of this change is the shift of investment funding away from direct budget resources of all levels of government to enterprise profit-based funds, and, to a lesser degree, to resources of the non-state investors. This trend started in 1987 during the first year of enterprise reforms. The current composition of financing has changed profoundly as follows:

—The share of state or parastatals funds which was about 84 per cent in 1986 declined by a modest amount to about 80 per cent in 1993. However, the composition of this state financing is dramatically different and greatly more decentralised. The contribution of central budget financing to the total production of new stock has fallen rapidly from 84 per cent in 1986 to only 8.3 per cent planned for 1993. The share of ‘departmental’ funds has skyrocketed from zero in 1986 to over 50 per cent in 1993. As enterprises are being privatized, this line of funding will be moving to the private sector.
—Because of the particularly difficult housing conditions of military personnel, defence budgets—at least for 1993—are expected to play a significant role and to finance 15 per cent of total housing investment.
—The local government share of new construction has risen from zero to a modest share of 6 per cent.
—The share of financing from the population going into new construction through housing cooperatives and individual construction had increased from 5.4 per cent and 5.9 per cent respectively in 1986 to 6.2 per cent and 10.6 per cent in 1992. Due to the decline in household incomes, this share was expected to decline back to 7.0 per cent in 1993.
—The share of Russian-style private-sector enterprises (business cooperatives) and other organisations supporting their staff needs rose from zero in 1986, when they were still prohibited, to about 10 per cent in 1993. Some mid-term government projections of new housing construction for the 1993–95 period envisage a negligible contribution of housing cooperatives, but a 13–15 per cent share of individual construction.

Sharp Contraction of the Building Industry Output

Changes in the sources of funds coincide with a major contraction of the flow of funds for housing investment, and maintenance as well. Due to preferential treatment by the Central Plan, the construction of new housing had been rising in the late 1980s when many other types of investment were being reduced. However, by any measure, the residential building industry in Russia is in crisis today:
1) In terms of total housing stock, in 1990, floor area per person in Moscow was 17.8 sq m and in Russia it was 16.4 sq m, compared with typical floor areas per person in developed Western countries of 30–45 sq m and over.

2) Looked at through the flow of new housing, production of new dwellings has been declining at an accelerating pace between 1990 and 1992. The 1992 output of 28m sq m of floor space (or about 490 000 units) was only 38 per cent of the peak 1987 level of 72.8m sq m. The output in 1993 was similar to that of 1992. This level of new output barely matches the traditional volume of removals from the existing stock of dilapidated units, which was low by international standards.

3) Construction costs have experienced explosive increases with price liberalisation partly because the monopolistic production and distribution of materials and supplies has remained in place.

4) Construction delays are endemic because of misplaced incentives to start new projects rather than to finish existing works. There has also been a significant increase in the volume of unfinished construction. In 1988, officially, work-in-progress represented 84 per cent of annual housing output; by 1990 it reached 103 per cent; while the estimate for 1991 had reached over 300 per cent.

Cuts in Operating Subsidies

With the shrinking of funds for new construction, the time-honoured diversion of maintenance funds in favour of new construction has worsened. Appropriations for maintenance and repairs have fallen from 60–70 per cent in 1990 to 25–30 per cent of needs in 1992 and 1993 according to Gosstroy (Construction Committee) estimates. Scheduled capital repairs had already fallen from 43.8m sq m to 20.0m in 1991. These cuts apply to housing maintenance estimates which are chronically underestimated.

—In 1992, the recognised housing and housing-related subsidies and transfers constituted at least 6.1 per cent of all federal budget expenditures and 2.2 per cent of GDP. However implicit housing subsidies, especially energy subsidies remain large.
—Responsibility for the maintenance and operation of the existing stock was passed in 1991 to local governments. With price liberalisation, housing-related subsidies are growing rapidly and were feared at one time to reach 12 per cent of all local budget expenditures in 1992. Unfortunately, they have ballooned to 25 per cent in 1994 (see Table 6). As noted, local governments are compressing housing maintenance costs to around 4 per cent of their budgets through massive deferred maintenance and therefore a sharp reduction of the flow of municipal housing services.

Low Housing Affordability and Weak Effective Household Demand

Under central planning, production decisions were made in the plan. Imbalances between the true production cost of new housing units and the limited purchasing power of households were irrelevant since housing was provided as a form of income in-kind and allocated administratively. Under a market-based system, housing affordability by households can be monitored by measuring the ratio of the median sale price (not production cost) to median annual household income. This housing price-to-income ratio or PIR value is a key indicator of housing affordability. It reveals the relative balance between demand and supply conditions: the lower the PIR value, the better the market is because ownership is readily affordable to the population. In well-functioning markets, PIR values range from under 3 to about 4. Today, PIR values are high and unstable in Russia due to high inflation, very rapid shifts in relative prices, abrupt increases in materials and construction costs, and sharp divergence in inflation-adjusted household incomes. All of these apply to fragmented emerging urban markets.
Table 5. Ownership and share of housing in national wealth

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage share of housing in national reproducible assets</th>
<th>Percentage share of these housing assets privately owned by households or institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>France 1970</td>
<td>43</td>
<td>89</td>
</tr>
<tr>
<td>Germany 1977</td>
<td>33</td>
<td>96</td>
</tr>
<tr>
<td>UK 1975</td>
<td>26</td>
<td>80</td>
</tr>
<tr>
<td>USA 1990</td>
<td>39</td>
<td>97</td>
</tr>
<tr>
<td>Russia 1990</td>
<td>20</td>
<td>14</td>
</tr>
</tbody>
</table>

Sources: various national studies and statistical agencies.

The transition from predominantly state-financed housing to housing markets where the great majority of households pay full price for their housing is difficult. Direct sales of new units to a broad segment of the population are constrained by low wages leaving very little room for savings and housing finance. Pending full wage reforms and until economic recovery, private demand seems destined to remain constrained by the rate of growth of the grey or second economy. The issue of who can afford housing at full cost and who can afford housing at reduced costs with the help of subsidies is a central concern. However, a major and readily available remedy is the rapid privatisation of housing which will give many households an asset which can withstand inflation and be traded if and when needed.

The inflation-adjusted income of most social groups has been declining. Overall, in December 1992 the real wage level was only 47.7 per cent of the December 1991 level. Of total income, 64.5 per cent was spent on food by the Russian population during the third quarter of 1992. For poverty groups, this food share is 68.3 per cent. The official social minimum, which was estimated at Rbs 2150 per month in September 1992, has been adjusted several times since then. Fortunately, by 1994 the very high food coefficients had recovered somewhat.

—Economic conditions have brought significant changes in the population’s income distribution. Analyses of the joint Goskomstat–World Bank income monitoring survey show that about 37 per cent of the total population was below the Russian definition of the poverty line in 1992. The data suggest that the top quintile of the population may have incomes twenty times higher than the poorest quintile. Thus, in ten years, the Russian household income distribution would have deteriorated from being similar to that of the UK to one now similar to Brazil’s.

—Inflation in construction and building material costs was extremely severe in 1992. The cost per sq m rose in 12 months from 900 to 11 000 roubles for large-panel buildings. Minstroy (Construction Ministry in operation during 1992) and the Economy Ministry estimate that average construction costs could reach 50 000–60 000 roubles in 1993. For maintenance, O&M costs rose from Rbs 4.5 to 80.0 per sq m per month but cover only 30 per cent of requirements instead of 70 per cent. These nominal costs continue to rise on a monthly basis and relative real prices keep shifting very rapidly.

—Under these conditions, housing price-to-income ratios (PIR values) are high and unstable. The average monthly household income in 1992 is approximately Rbs 6750 (or Rbs 81 000 per year) while the cost of a typical apartment of 55 sq m ranges between Rbs 0.4 and 1.1m or about 5–13 times annual income. Auction prices are considerably higher and reflect business rather than household transactions. The resulting PIR values are indicative of the
Table 6. Local authorities’ operating subsidies, Russia

<table>
<thead>
<tr>
<th>Costs of operation (roubles per sq m)</th>
<th>January 1991</th>
<th>January 1992</th>
<th>January 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintenance and current repair</td>
<td>1.0</td>
<td>2.9</td>
<td>14.0</td>
</tr>
<tr>
<td>Utility costs</td>
<td>1.1</td>
<td>6.7</td>
<td>54.0</td>
</tr>
<tr>
<td>Total cost</td>
<td>2.1</td>
<td>9.6</td>
<td>68.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tenant payments (roubles per sq m)</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintenance and current repair</td>
<td>0.12</td>
<td>0.12</td>
<td>0.12</td>
</tr>
<tr>
<td>Utility costs</td>
<td>0.26</td>
<td>1.00</td>
<td>4.00</td>
</tr>
<tr>
<td>Total payments</td>
<td>0.38</td>
<td>1.12</td>
<td>4.12</td>
</tr>
</tbody>
</table>

| Total payment/Total cost (percentage) | 18.10 | 11.67 | 6.06 |

Sources: Office of Housing Reform, Ministry of Construction, Russian Federation.

demand for commercial estate and emerging land markets. In Moscow, units in peripheral locations were selling in early 1993 for Rbs. 2.4m (PIR = 29) and for Rbs. 7m (PIR = 86) in Central Moscow (See Table 7).

Lengthening Waiting Lists

Longer enterprise and municipal waiting lists are a direct result of the sharp contraction in the delivery of new housing units to 40 per cent or less of the 1987 output. The number of households registered on waiting lists has risen from 8.0m in 1986 to an estimated 10.3m in 1992. The percentage of urban households in the housing queues (including one-person households) is over 23 per cent of the total number of urban households. These lengthening waiting lists are caused by the greater rate of job changes, more internal migration, and a much faster rate of household formation than of total population growth. Because of these lengthening waiting lists and rising prices for daily necessities which local governments subsidise, they objected to abolishing the propiska which finally happened in 1993. The propiska system as a means of population control was a blunt and crude administrative instrument with high economic efficiency and equity costs. As a better alternative, local governments are considering targeted housing programmes and selective social safety net measures.

Positive Adjustments in Housing Technology

Changes in the sources of residential construction financing favour greater control over quality, design and prices by clients and households as ultimate owners. These changes are expected to lead to a shift away from the large-panel, high-rise buildings towards more attractive low-rise buildings that can be quite efficient in terms of land use. They are also expected to lead to improvements in housing unit prices which must be in line with the purchasing power of the population. Diversified financing will encourage diversified technologies such as traditional brick and wood technologies, and small prefabricated elements for low-rise and individual housing construction. The share of large-panel industrial housing in total output is expected by Ministry to fall from 52 per cent in 1991, to 42 per cent in 1992, to a combined share of large-panel industrial and related technologies of approximately 20 per cent by 1995. One effect of the 1992 price liberalisation is to bring into full view the fact that this capital- and energy-intensive housing technology delivers a mediocre product which is also one of the most expensive types of housing construction.
Fiscal Decentralisation and New Burdens on Local Governments

The system of inter-governmental finances is in transition. The restructuring of fiscal relations and municipal finance reform has just begun. New federal laws and decrees have burdened local governments with extensive mandatory responsibilities, without providing a stable and predictable revenue base. Given these circumstances, cities are barely coping with increased housing costs. The problem of covering deficits incurred in operating and maintaining the existing stock is bad, the lack of funds is even worse for housing investment. Local government funds cannot replace central budgets for housing construction. This central share fell from 74 per cent in 1987 to approximately 13 per cent in 1992. This meant a real cutback from 970,000 units in 1987 to about 80,000 in 1992.

The short-term coping strategies currently used by local governments are not a substitute for a strategy to manage their local housing sector. In particular, most local governments do not have meaningful financial plans against which they can gauge alternative options. Ad hoc decisions could have serious detrimental effects both within the housing sector and at the city level. Cutting the volume of current repairs and rehabilitation is causing an accelerated deterioration of the already badly decapitalised stock. The practice of deferring all but the most essential payments to utility companies and other service enterprises appears to be almost universal. Local services enterprises—particularly housing organisations which have few goods to trade—appear to be at the end of the long chain of arrears against which they have little leverage. Too often, local governments are disposing of non-residential capital assets to finance current expenditures—a financially undesirable practice, especially in times of high inflation.

A Housing System in Flux

The Russian housing system is now in a state of flux. So far, the traditional mechanisms of central planning are breaking down faster than market mechanisms are emerging. A whole society has to re-learn and re-create the conditions of a demand-driven housing market; that is to say, a system where individuals make their own decisions and not government bureaus. Russians have described the 1992 Fundamental Law of Russian Housing Policy as their ‘Housing Bill of Rights’ (see below). Shifting relative prices are a reform necessity, but high inflation and the contraction of output in the sector do not facilitate the transition to markets. This transition has two main dimensions: restructuring of the existing stock, and encouraging the emergence of a competitive, market-based production of new housing.

The ownership of the housing stock until mid 1992, was approximately: 38 per cent in municipal ownership; 40 per cent in departmental ownership including state enterprises; 6 per cent in state-controlled cooperatives; and only 16 per cent in individual ownership, most of it located in the smallest cities. Given the economic conditions prevailing in Russia, rapid and voluntary privatisation of the housing stock is a high priority. The pace of tenure change has been dramatic beyond expectations. By mid 1994 it was expected that private ownership would rise to close to 55 per cent in many cities, and even higher in Moscow (Goskomstat, monthly reports on housing privatisation). In managing the transition, the government of Russia faces several constraints. First, the old state system and the new market system will co-exist for some time. Nobody should expect that a Russian housing system with more than 90 per cent of the stock in public ownership in all large cities in 1990 would overnight transform itself into a US housing system with 2 per cent of the stock in public ownership which is the lowest level in Western countries. There are too many unresolved social safety net issues. Efficient, preferably private, forms of new management of the remaining public housing stock must complement privatisation of the public stock.
The transition to markets of the production of new housing has many large legal and institutional requirements. At heart, however, it means moving from needs-based, state-financed housing construction to demand-based, private financing of real estate development. Due to the economic crisis, most state financing has been abruptly cut. The substitute development of a market-based supply of long-term finance has four major requirements: first and foremost, economic stabilisation and the end of inflation; secondly, the privatisation of land and the development of basic land market institutions; thirdly, good mortgage and foreclosure laws and regulations; fourthly, sound mortgage lending services by banks. Meanwhile, employer organisations, be they old-style departmental units or new private and privatised enterprises, have become the main source of funds for the time being.

**Housing and Enterprises**

Successful housing reform demands that the direct production and management role of enterprises and employers in providing housing comes to an end. Freeing enterprises and other employers from housing activities in which they have no comparative advantage is more than a housing sector requirement, it is an economy-wide need. Cutting the Gordian knot tying together in a most inefficient way enterprises, housing and labour markets has at least two dimensions. The first need is to reduce as rapidly as feasible most departmental ownership of existing housing through privatisation of units to households. The second need is to restructure existing social funds financing new housing so that they will fall under the direct controls of future household owners and can finance a competitive privatisation of housing production. Voucher systems can also play an important role. Given existing industry skills in Russia, privatisation of the building industry itself will proceed very rapidly when the three local monopolies over access to finance, to urbanised land and to building materials are eliminated.

**Notes**

1. Under the Soviet administrative-command system, ‘departmental housing’ refers to housing belonging to ministries and their subordinated enterprises, or to non-production-oriented government agencies. This designation contrast with municipal housing belonging to cities and towns, cooperative housing, and individual housing which does not carry the same rights as private housing in a market economy. Each form of tenure has its own financing mechanisms and operating features.

2. It takes a doctrinaire mind and little common sense to argue that “one implication is that prices of liquors and cigarettes are too high” (anonymous referee). There have been two Russian answers to such an outlandish statement. One was political, it is Gorbachev’s anti-vodka campaign and its explicit reference to housing (see Aslund, 1991). The other is analytical: Shironin (1990) estimated that by 1988 the true resource cost of a housing unit was typically six times the official accounting price used by housing administrations. Distortions and hidden losses were massive. The mismatch between true costs and rent explains low and declining maintenance levels. This resource gap could be seen in the never-ending housing shortage, except for the nomenklatura.

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