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# **RUSSIA: URBAN AND REAL ESTATE REFORMS in THE PUTIN ERA**

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**10 March 2006**



I.

# **BASIC FACTS ABOUT RUSSIA: A QUICK OVERVIEW**

# RUSSIA: BASIC FIGURES



- **AREA:** 17 Million km<sup>2</sup>, 11 time zones. Next largest: Canada: 9.9 , China: 9.6 , USA: 9.3
- **POPULATION:** 145.3 million (Census 2002). Declining by about -0.5% per year.
- **TOTAL GDP 2005:** €bn390 or \$bn700 (Just became larger than the Netherlands)
- **GDP per capita (USD):** \$5,183 in 2005. PPP GDP per capita: \$10,781
- **REAL GDP GROWTH:** 6.1% 2001-2005. 2006 forecast: 11% (Financial Times)
- **INFLATION RATE 2003:** 14.8% 2001-2005, 2006 forecast 8%
- **POSITIVE BUDGET BALANCE:** 2003: 1.6% of GDP. 2004: 2.6%. 2005: 2.2%. 2006 projection: 1.6%
- **CURRENCY RESERVES:** \$bn 65 in 2003 ( rising from \$bn14 in 1999, and still growing)
- **SOVEREIGN RATING:** Investment grade (BBB+, Feb 15, 2006, S&P), positive trend
  
- **Russian Federation:** 89 oblasts or republics, grouped into 7 Federal Districts
- **Head of State:** Vladimir PUTIN, re-elected in March 2004 ( 4-year term). Inaugurated 7 May.
- **Executive branch:** Massive reorganization in 2004: from 30 to 17 ministries.
- **Two-chamber legislature** (4-year mandates).
  - **State Duma:** 450 deputies
  - **Federation Council:** 178 deputies (2 from each region or republic)
- **Main parties: (Last election: December 2003)**
  - United Russia (formerly Fatherland-All Russia Unity Party)
  - Communist Party of the Russian Federation (CPRF)
  - Motherland (Rodina)
  - Liberal Democratic Party of Russia (LDPR)
  - Yabloko
  - Union of right forces (SPS)

# FIRST DECADE OF TRANSITION, 1989-1999



- Disastrous contraction of Russia's economy after 1989: worse than the "Great Depression" of the 1930s.
- Struggle to establish a market-oriented legal and regulatory framework for real estate:
  - Concept of 'real estate' disappeared in Russia after 1917: no land markets
  - 2001 Land Code finally accept the concept of private ownership of land (mostly for urban areas)
  - 2001 Key elements of real estate included in the Civil Code the same year
  - 2004 Massive federal government reorganization: from 30 to 17 ministries (Gosstroy disappears!)
  - 2004 Housing: Putin's "Presidential Legislative Package" (27 laws affected)
  - 2004 Intergovernmental relations: Presidential package of "Kozak Committee" laws to be implemented in 2006

WARNING: The concept of "law" in the Western sense has had a hard time taking hold.

- For 400 years laws were mostly instruments of administrative convenience
- From imperial 'ukaz', to Soviet "ukaz", to Putin 'ukaz'?
- Deep concern of young Russians for the establishment of a 'civil society' where rights are protected and governments can be challenged and successfully taken to court.



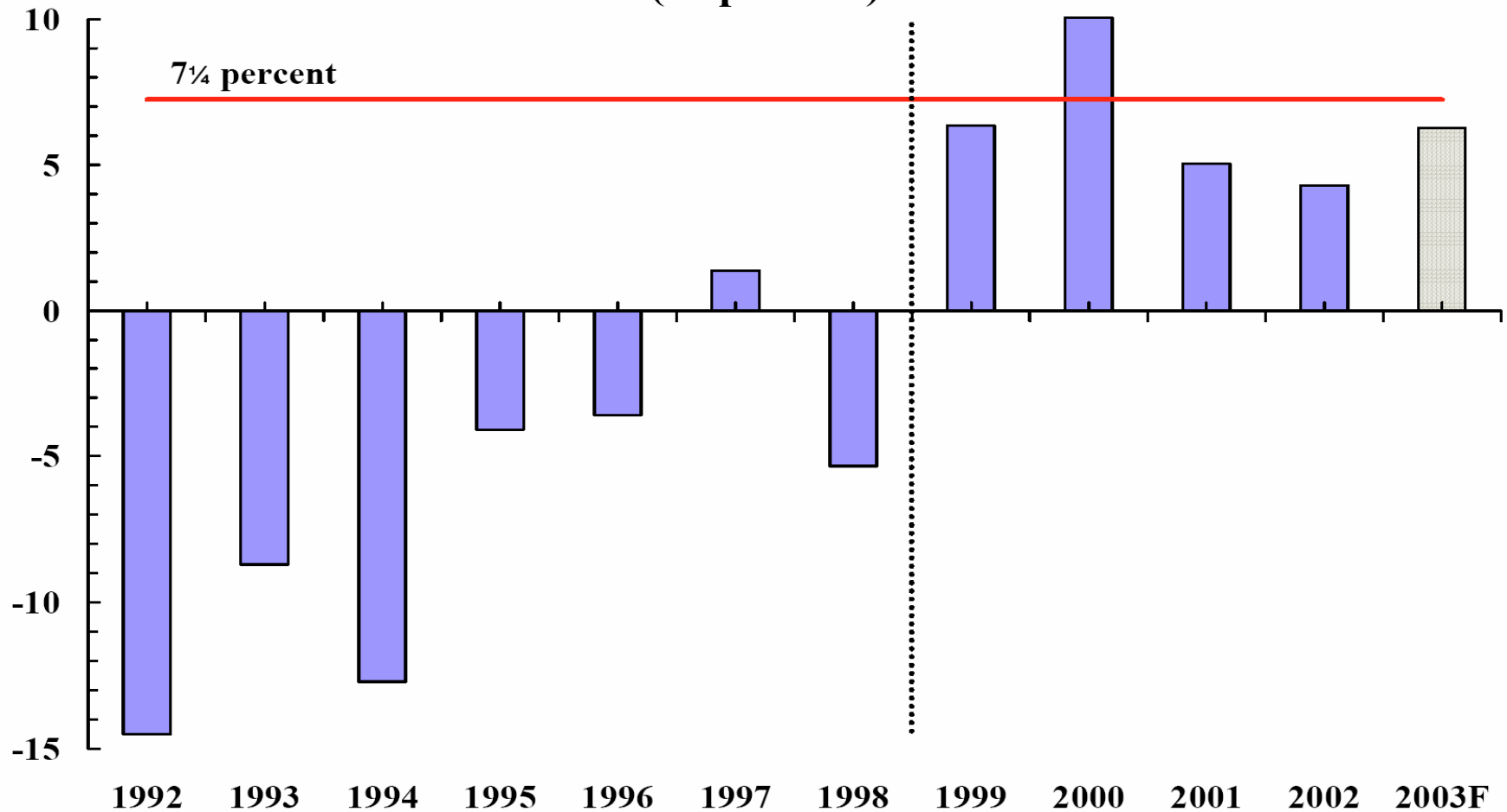
## II.

**BEYOND THE GROWTH REBOUND:**

**URBAN REFORMS ON THE  
CRITICAL PATH OF GROWTH**



## Figure 1: GDP growth (In percent)



Source: David Owen, IMF, 11 December 2003 presentation



Behind the impressive economic growth since 1999 are:

1. Important **temporary** factors:

- the ruble devaluation,
- the rising price of oil,
- the strong response of import-competing sectors

2. Major **structural improvements** in **macroeconomic policy**:

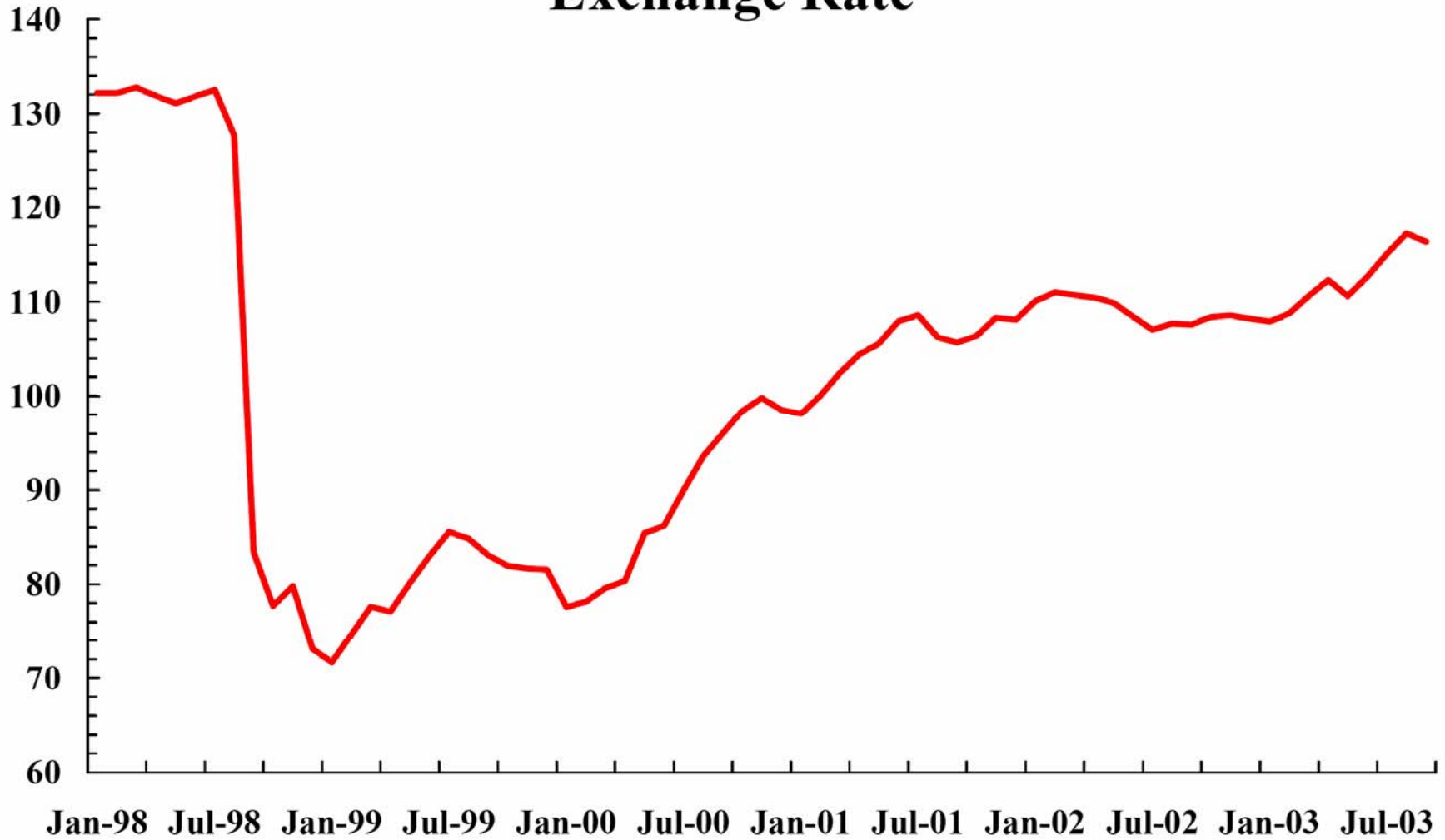
- monetary policy
- fiscal policies and tax reforms (13% flat individual income tax, 2001)

3. **Government reforms**, the “Kozak” reform package submitted to the Duma in 2004, in force in 2006: greater uniformity, recentralization

- “Subject governments” of the Federation:
  - 89 Oblasts and republics
  - Local Governments
- Impact: 153 federal laws to be amended, 35 eliminated

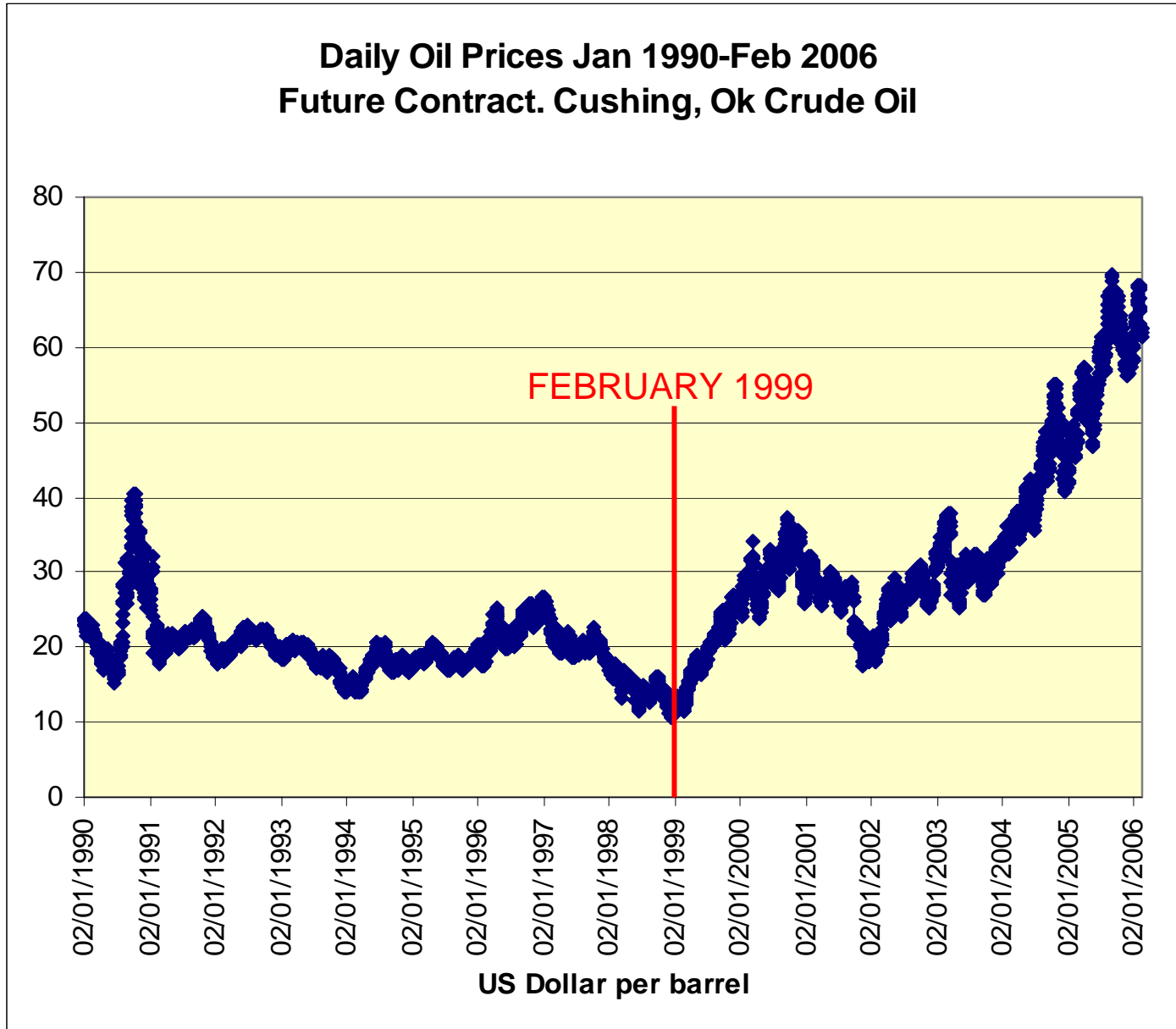


## Exchange Rate



Source: David Owen, IMF, 11 December 2003 presentation

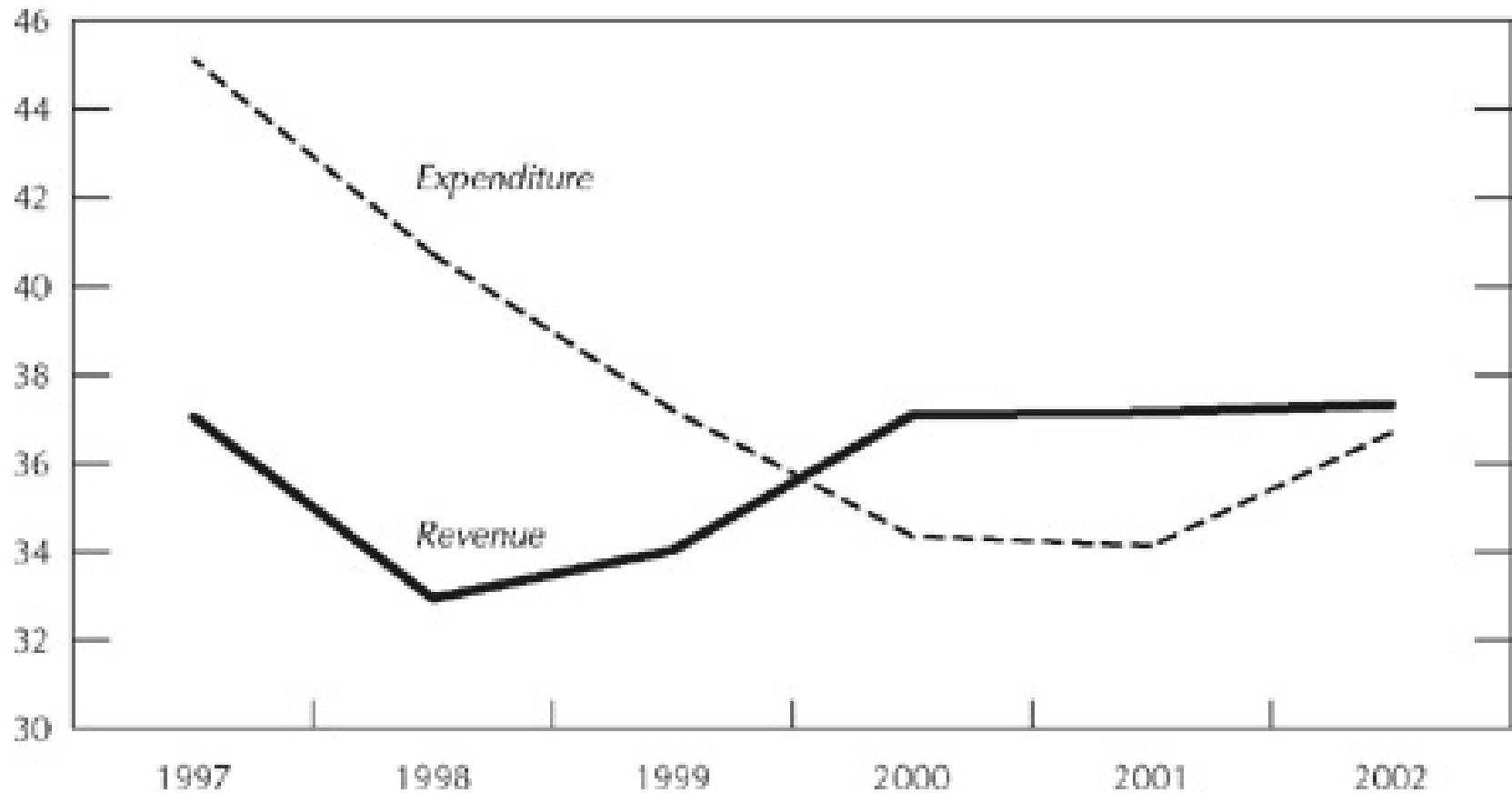
# OIL EXPORTS : MAJOR CONTRIBUTORS TO THE REBOUND



# TURNAROUND IN FISCAL POLICY



**Figure 1.4. General Government Revenue and Expenditure**  
*(Percent of GDP)*

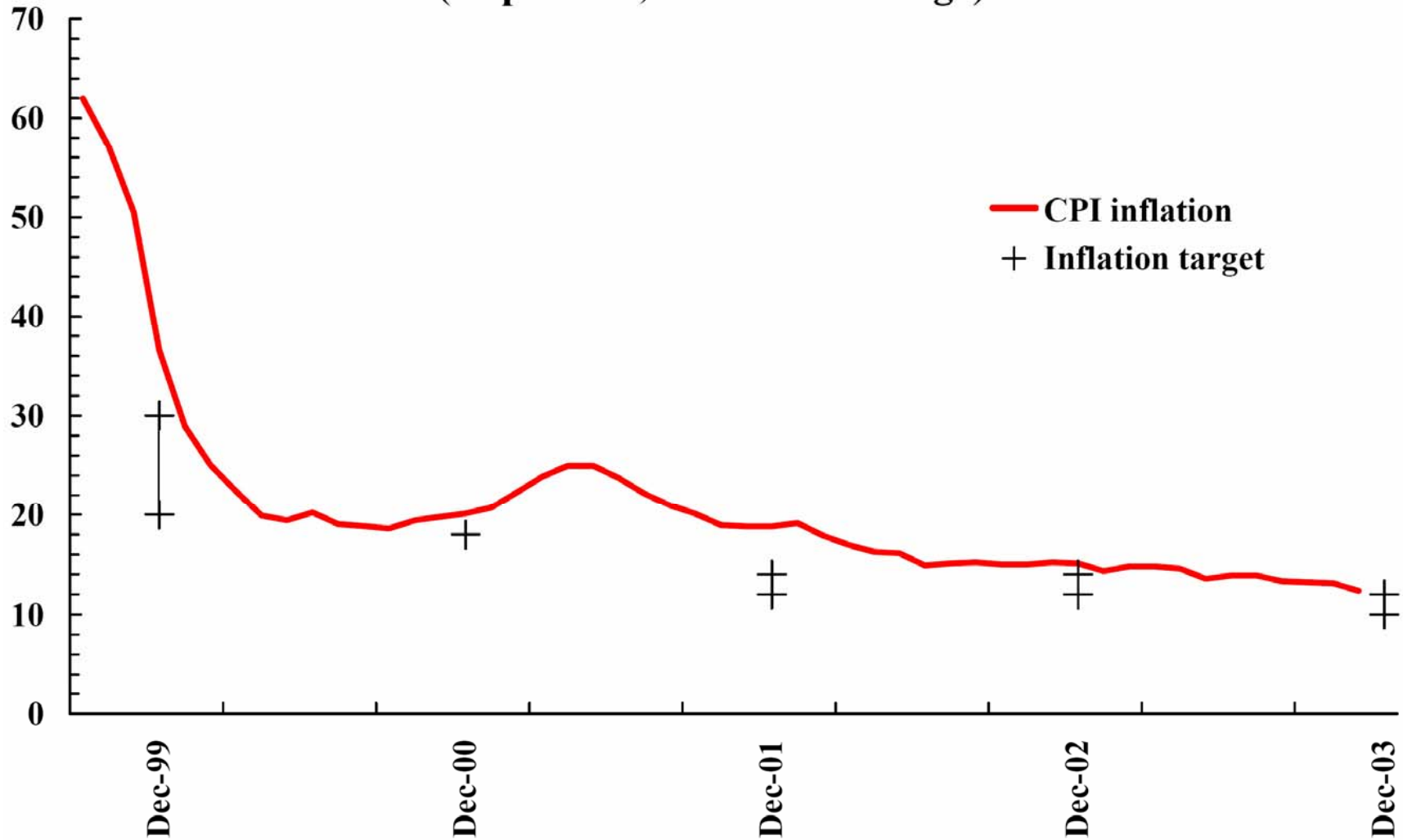


Source: David Owen and David Robinson, *Russia Rebounds*, Overview, IMF, 2003

# MONETARY POLICY AND CONTROL OVER INFLATION



(In percent, 12-month change)



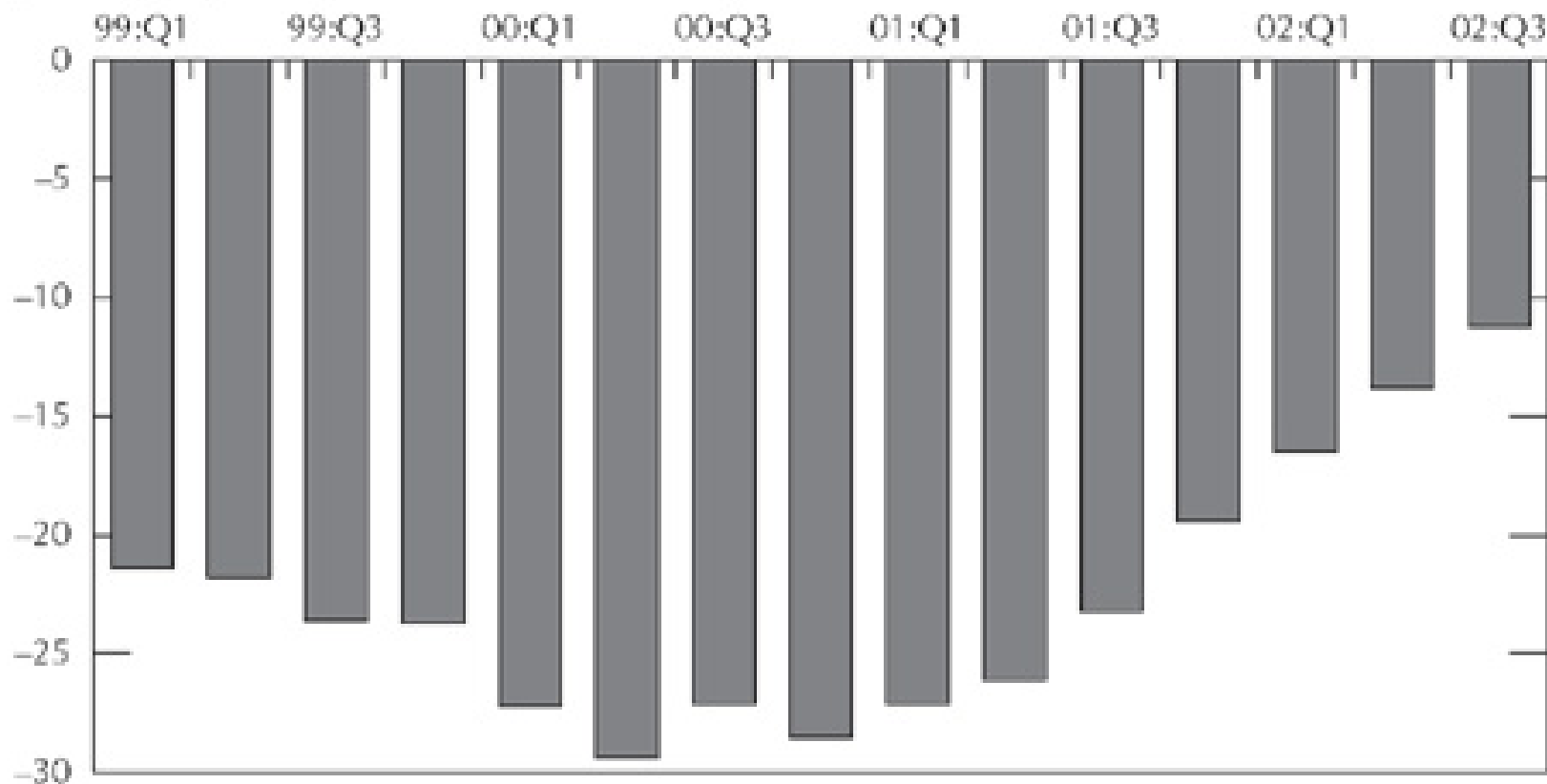
Source: David Owen, IMF, 11 December 2003 presentation

# CAPITAL FLIGHT: IS THE END IN SIGHT?



Figure 1.6. Total Net Private Capital Flows<sup>1</sup>

(Trailing 4 quarters; billions of U.S. dollars)



<sup>1</sup>Sum of all nongovernment items in the financial and capital accounts of the balance of payments, plus net errors and omissions.

Source: David Owen and David Robinson, Russia Rebounds, Overview, IMF, 2003



- Economic rebound: narrowly based, driven by natural resources and related sectors
  
- Russian government objectives today:
  - Consolidate successes of recent years and maintain stable growth
  - Widen and deepen restructuring and international opening of the economy
  - Double the size of the economy in 10 years (7.25% annual growth)
  
- These goals imply major structural changes that are urban-based:
  - Diversification into new industrial and services activities
  - Expansion of the small and medium enterprise sector
  - Sustained productivity increases
  - Broadly-based opening to the international economy
  
- ➔ This strategy **requires** a sound real estate sector: for service firms and SME enterprises, real estate costs rank second only to labor costs



- Need for **completion of institutional reforms**:
  - Consistent implementation of laws in the books a major concern (“Rule of Law”)
  - Lack of a comprehensive and integrated housing policy to coordinate government actions
  - Soviet legacy persists: new construction and “square meters” planning mindset rather than consumer choice and value for the users.
- Urgency of reforms of the **Housing & Community Services** system or “**HCS sector**”
  - Separation of housing maintenance services from utility companies
  - Tariff reforms, metering and full cost pricing in provision of utility services
- **Creation of a mortgage finance system: much work to do! Another topic...**
- **Reform of local governments** who play a *major but erratic role* in:
  - Management of “HCS sector” subject to unfunded federal mandates (*I’goti*)
  - New residential and non-residential real estate investments (local oligopolies)



**III.**

**FACTORS SHAPING THE REFORMS:**

**A VERY DIFFERENT 21<sup>st</sup> CENTURY !**

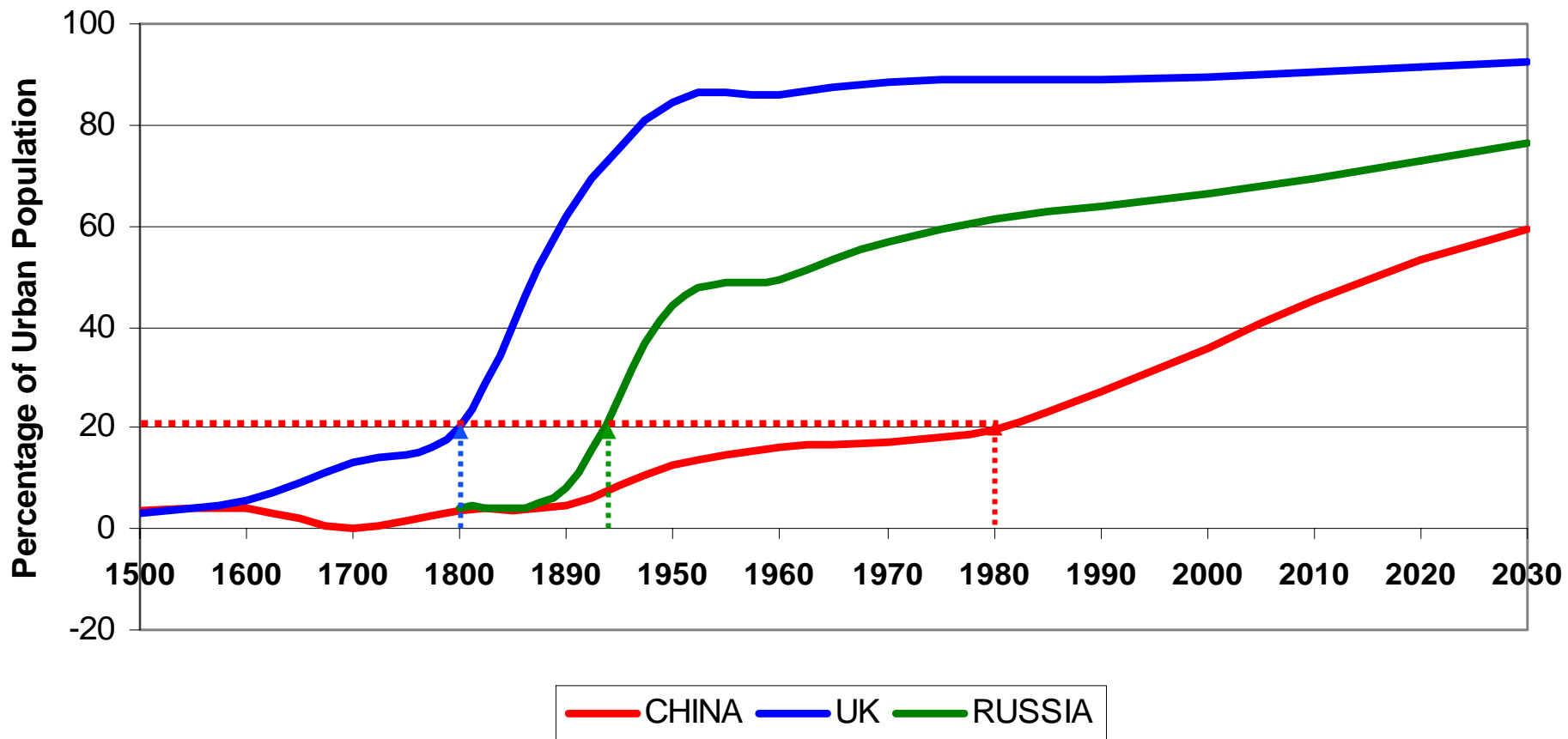


## A. DIRE DEMOGRAPHICS

# URBANIZATION IN THE UK, RUSSIA AND CHINA ,1500-2030



## URBANIZATION IN CHINA, THE UK AND RUSSIA , 1500-2030



Source: Angus Maddison [2001], The World Economy, OECD, plus UN data



# 'CHRISTMAS TREE' SHAPE OF RUSSIA'S DEMOGRAPHIC PYRAMID

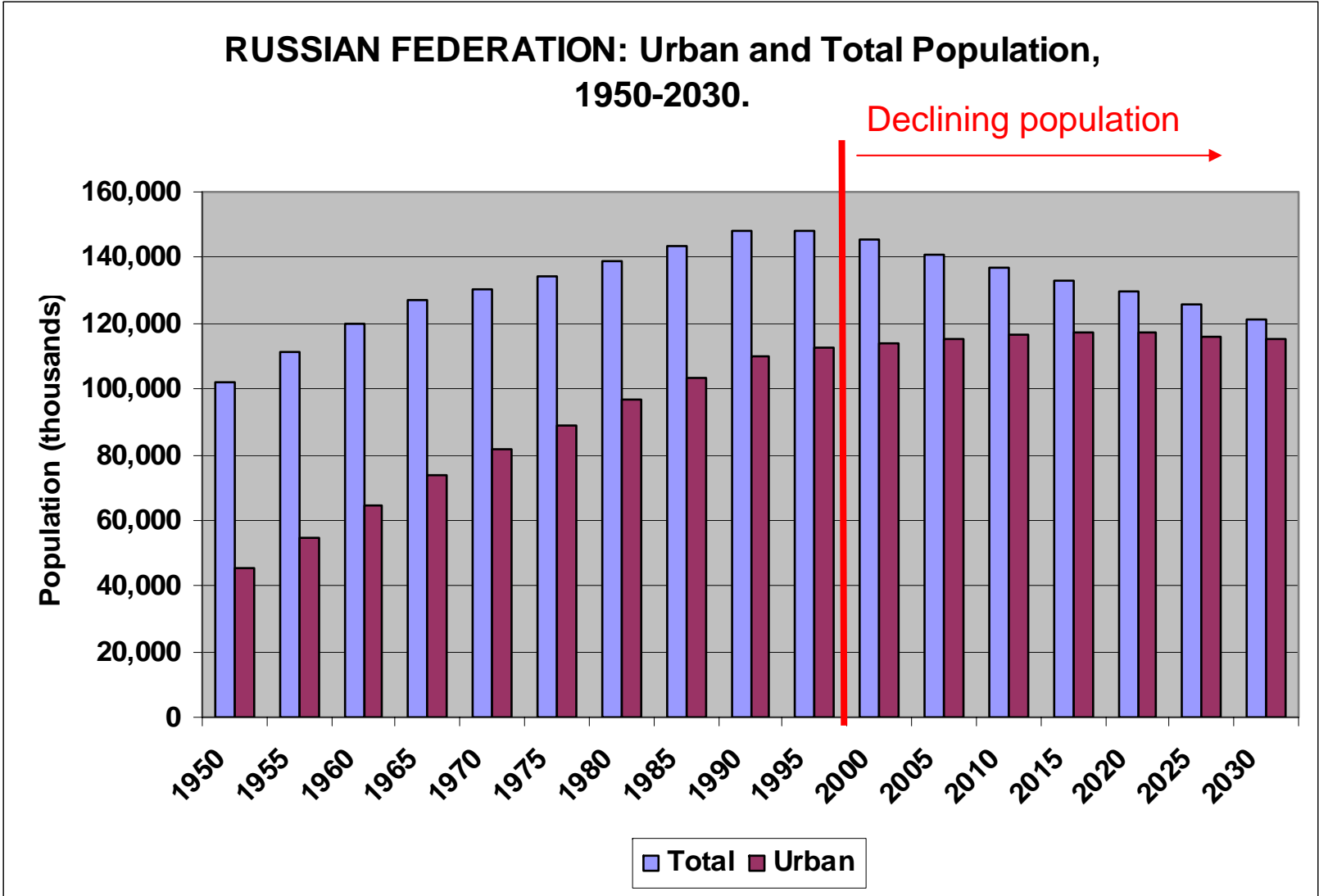
RAND MR1273-5.2



SOURCE: INED (2000).



# OVERALL POPULATION DECLINE and URBAN 'ZERO-SUM GAME'



# RUSSIA'S SHRINKING URBAN SYSTEM



Ten Largest Urban Populations of the World in 1950, 2000, 2030

(In millions)

	1950			2000			2030		
	Country	Urban	Share	Country	Urban	Share	Country	Urban	Share
1	USA	101	13.50%	China	456	15.90%	China	883	17.70%
2	China	70	9.30%	India	279	9.70%	India	576	11.60%
3	India	62	8.20%	USA	219	7.60%	USA	303	6.10%
4	Germany	49	6.50%	Brazil	138	4.80%	Brazil	205	4.10%
5	<b>RUSSIA</b>	<b>46</b>	6.10%	<b>RUSSIA</b>	<b>106</b>	3.70%	Indonesia	180	3.60%
6	UK	43	5.70%	Japan	100	3.50%	Nigeria	140	2.80%
7	Japan	42	5.60%	Indonesia	87	3.00%	Pakistan	133	2.70%
8	Italy	26	3.40%	Mexico	74	2.60%	Mexico	110	2.20%
9	France	24	3.20%	Germany	72	2.50%	Japan	103	2.10%
10	Brasil	20	2.60%	UK	53	1.90%	Bangladesh	99	2.00%
11							<b>RUSSIA</b>	<b>95</b>	1.80%
	<b>WORLD</b>	751	100.00%	<b>WORLD</b>	2862	100.00%	<b>WORLD</b>	4981	100.00%

Source: *World Urbanization Prospects 2001*, UN Population Division, Table 33



## **B. REGIONAL & URBAN SYSTEM: WORSE AFTER THE DEPRESSION DECADE**

# RUSSIAN SYSTEM OF CITIES, not integrated to the world economy



Source: Financial Times of London



## Five largest cities in Russia (2002 estimates)

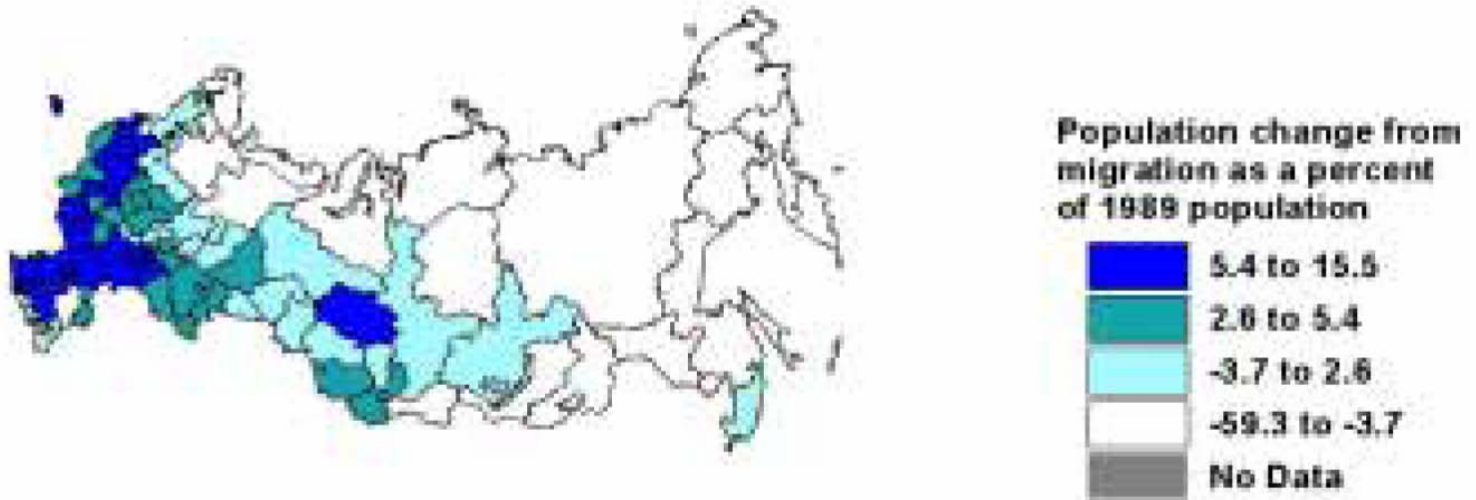
- **Moscow: 10.1 million**
- **St Petersburg: 4.7 million**
- **Novosibirsk: 1.4 million**
- **Nizhny Novgorod: 1.3 million**
- **Yekaterinburg: 1.3 million**

## First decade of transition:

- **Concentration of domestic capital and FDI in Moscow, St Petersburg (over 60% of FDI)**
- **Massive restructuring of the urban system**
- **Restructuring when 1992-98 GDP growth was negative**



## Net Migration by Region in Russia, 1989 to 2002



Source: Goskomstat Rossi, Demographic Yearbooks.

# THE 'NEW ECONOMY' HAS FAVORED A MINORITY OF REGIONS



## RUSSIA: Increasing Regional Concentration of GDP, Investment and Population, Between 1994 and 2000

Regional Quintiles	Share in Total GRP		Capital investment per capita (1994 prices)		Share of total capital investment		Share of total population	
	1994	2000	1994	2000	1994	2000	1994	2000
<b>Quintile 5</b>	37.9%	52.5%	1.1	1.1	43.0%	51.2%	23.6%	25.4%
<b>Quintile 4</b>	25.4%	21.3%	0.1	0.6	21.6%	22.8%	24.2%	26.1%
<b>Quintile 3</b>	19.1%	13.0%	0.5	0.5	18.6%	14.3%	22.7%	20.2%
<b>Quintile 2</b>	12.0%	9.4%	0.4	0.3	11.0%	8.7%	18.1%	18.0%
<b>Quintile 1</b>	5.6%	3.8%	0.3	0.2	5.8%	3.0%	11.4%	10.30%
<b>Russian Federation</b>	100.0%	100.0%	0.7	0.7	100.00%	100.00%	100.00%	100.00%

Source: Russian Economic Report No.4, World Bank, Russia Office, October 2002, p.11



## **C. RUSSIA'S VERY DISTORTED URBAN & REAL ESTATE SYSTEM**

# RUSSIA SCORES LOW ON A “LARA” RATING



- **LARA = Land And Real Estate Assessment** (a World Bank initiative)
- **Rationale:**
  - Land and real estate assets account for 45% to 75% of tangible wealth in developing and advanced economies
  - Without well functioning land and real estate markets no economy can reach its full potential
  - To be successful, reforms have to be based on a comprehensive framework, even if the implementation has to be phased over time
  - We need a tool for evaluating the current state of development of land and real estate markets to arrive at a better prioritizing and sequencing of needed reforms.
  - LARA ratings should permit third-parties to compare real estate systems across countries and identify areas for priority attention
- **Decision-tree approach to the actual diagnosis and rating work**
- **Three main categories of investigation:**
  - **“RIGHTS”**: Property Rights, Information, Contracting and Enforcement
  - **“FINANCE”**: Finance and Risk Management
  - **“MARKET”**: Real Estate Market Structure, Regulation, Fiscal Policy and Industry Structure

Complete diagnosis tool at : [http://www.worldbank.org/urban/re\\_dev/lara.pdf](http://www.worldbank.org/urban/re_dev/lara.pdf)

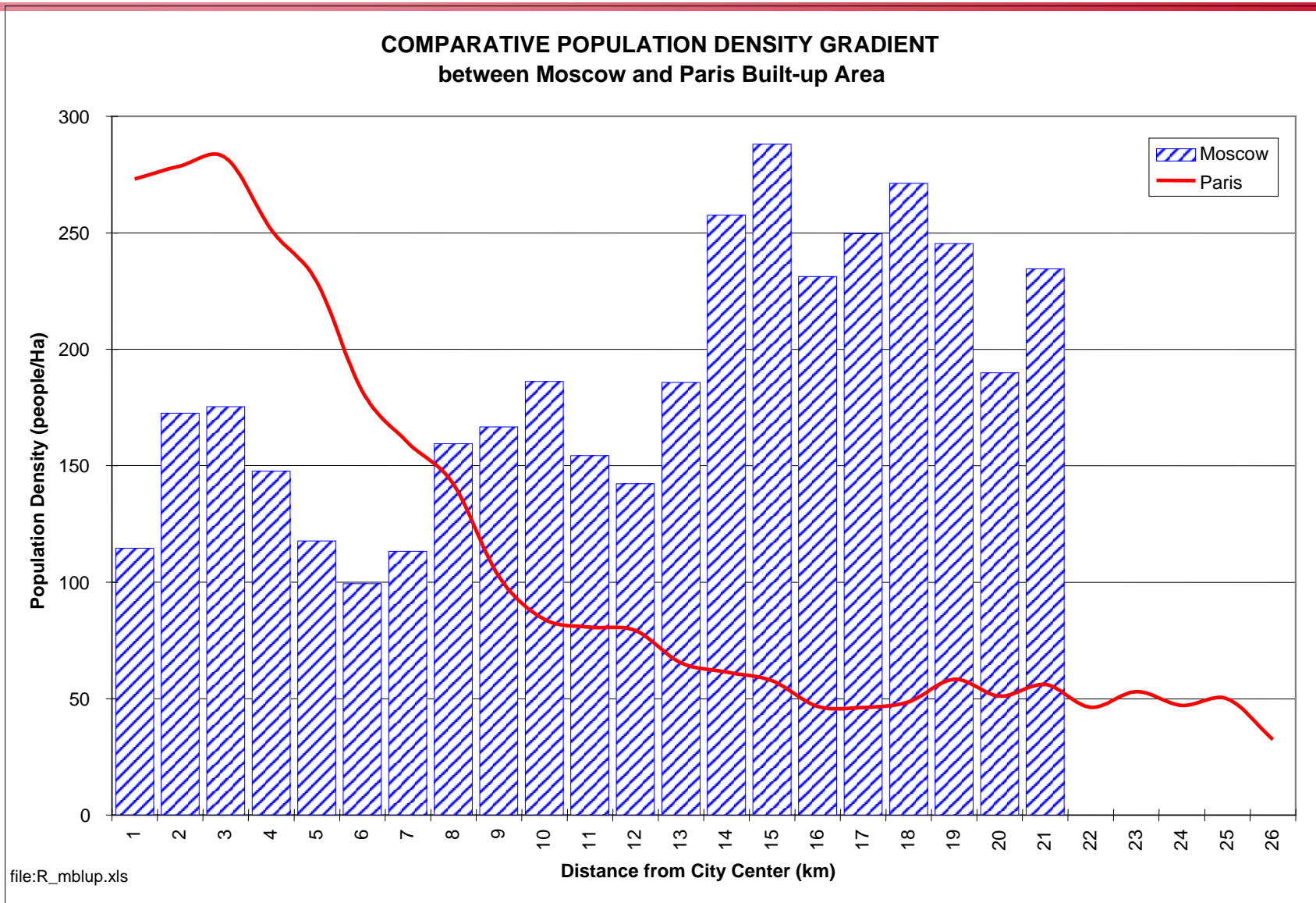


- “MARKETS” CATEGORY:
  - **Russian cities may have the most distorted internal spatial structure of all transition cities.**
  - Chinese cities are not severely distorted. Why? Mao anti-urban policies and urban investment freeze over the entire period 1949-1979.
  - The most extreme case of spatial distortion is likely to be Pyongyang, North Korea. (Renaud, 2003). Why? Pyongyang leveled during Korean War, then DPRK Soviet model.
- “RIGHTS” CATEGORY: The “**anticommons property**” problem arises in transition economies: privatization creates new property rights different from Soviet times when federal, oblast & local governments allocated land and building rights.

DEFINITION: “**Anticommons property** may appear whenever new property rights are defined. For example in Moscow, multiple owners have been endowed initially with competing rights in each storefront, so **no owner holds a bundle of useable rights** and the storefront remains empty” (Heller, 1997). (Refers to Moscow after initial privatizations, 1992-93)

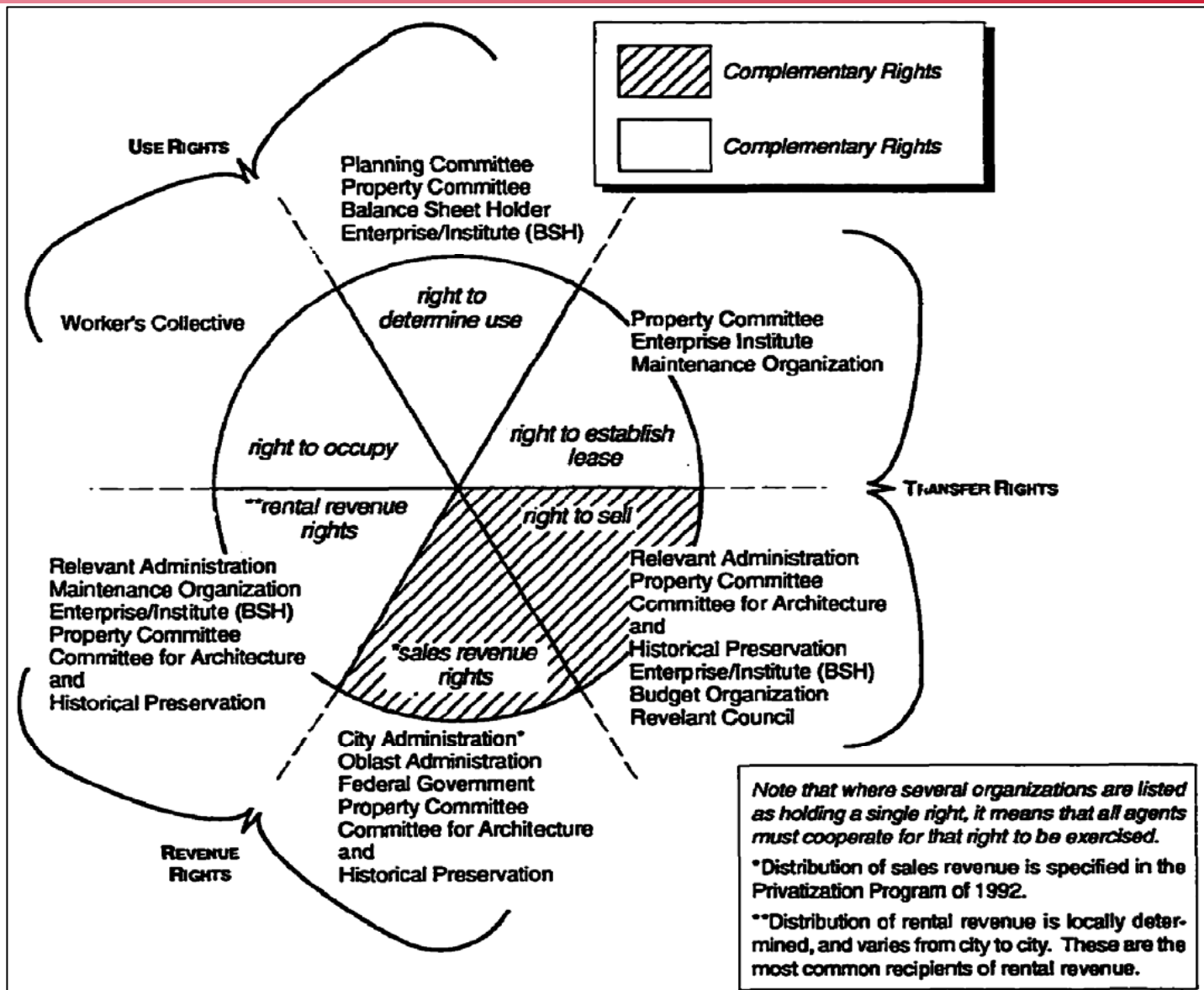
- “FINANCE” CATEGORY: **Russia's mortgage finance system is lagging far behind other transition economies.**
- Very large, opaque and risky shadow economy

# COSTLY SPATIAL STRUCTURE OF THE SOVIET CITY



Source: A. Bertaud, B. Renaud, "Socialist Cities With Land Markets" *Journal of Urban Economics*, 1997

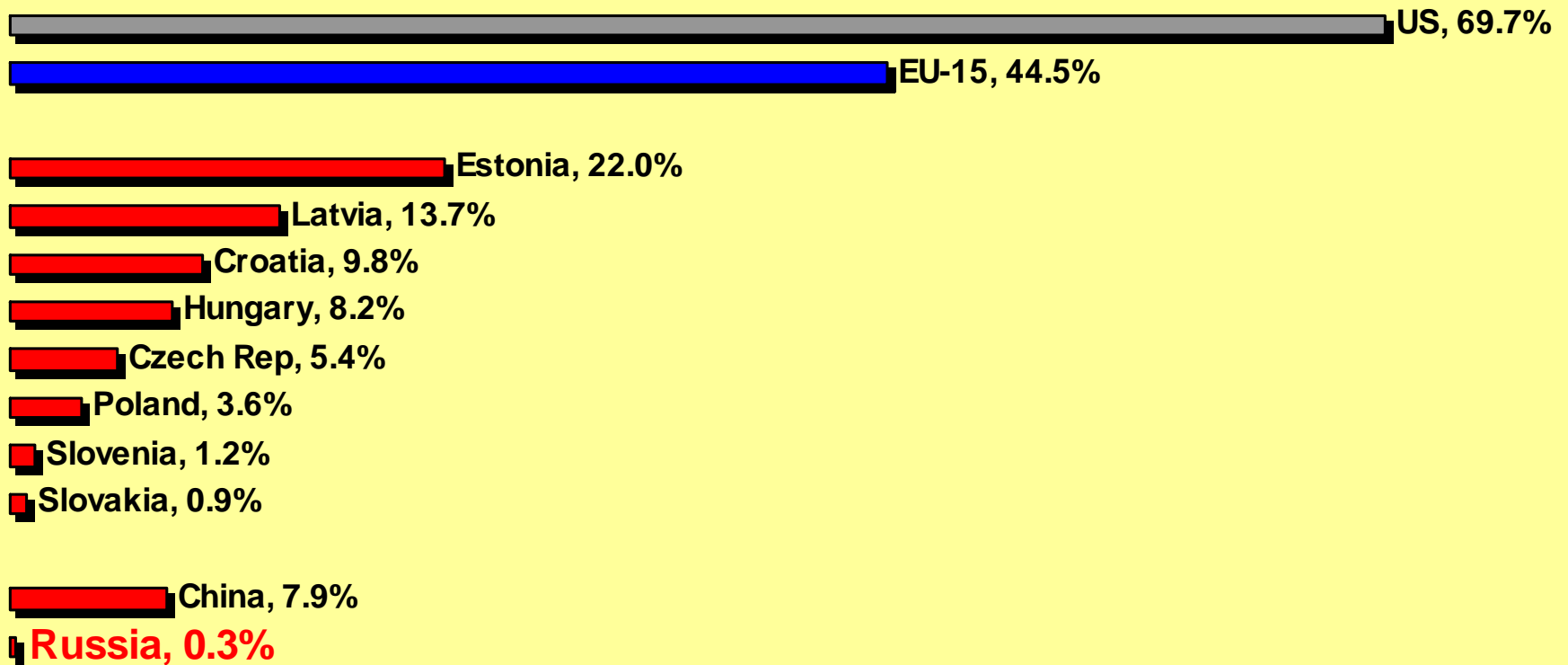
# RIGHTS FRAGMENTATION: THE "ANTI-COMMONS" PROBLEM



Source: April Harding, *Commercial Real Estate Market Development in Russia*, World Bank, CFS Discussion Paper 109, 1995



## DEPTH OF HOUSING FINANCE SYSTEMS, 2003 [ RATIO OF MORTGAGE DEBT OUTSTANDING TO GDP ]



# LARGE SHADOW ECONOMY IN RUSSIA (2000 Estimates)



	Shadow Economy: % of GNP 2000	Shadow Economy GNP per capita	GNP per capita 2000	PPP in 2000 per cap. US \$
Vietnam	15.6%	\$61	\$390	\$2,030
China	13.1%	\$110	\$840	\$3,940
<b>ASIA</b>	<b>26.0%</b>	<b>\$1,384</b>	<b>\$7,037</b>	...
Ukraine	52.2%	\$365	\$700	\$3,710
Armenia	46.3%	\$241	\$520	\$2,570
<b>RUSSIA</b>	<b>46.1%</b>	<b>\$779</b>	<b>\$1,690</b>	<b>\$8,030</b>
Moldova	45.1%	\$180	\$400	\$2,240
Croatia	33.4%	\$1,543	\$4,620	\$7,780
Poland	27.6%	\$1,156	\$4,190	\$9,030
Hungary	25.1%	\$1,182	\$4,710	\$12,060
<b>CEE &amp; CIS Economies</b>	<b>38.0%</b>	<b>\$742</b>	<b>\$2,354</b>	....
South Africa	28.4%	\$858	\$3,020	\$9,180
<b>AFRICA</b>	<b>41.0%</b>	<b>\$273</b>	<b>\$460</b>	...
<b>OECD</b>	<b>16.8%</b>	...	...	<b>\$27,450</b>



## **D. ROLE OF LOCAL GOVERNMENTS IN HOUSING & REAL ESTATE REFORMS**



**“In the Russian Federation, fiscally autonomous regions have often resisted market-oriented reforms, the enactment of rules protecting property, and the dismantling of price controls and barriers to trade [...] Fiscal incentives of the Russian regions represent an important determinant of regional performance”**

(Desai, Freinkman, Goldberg, World Bank WPS 3138, Sept. 2003)

- **New Law on Local Self Government and municipal reforms due to take effect in 2006. Many political and technical implementation problems today:**
  - **Two-tier local governments (choice no-longer left to regional governments)**
  - **New assignment of revenue sources, but no taxing powers !**
  - **Streamlining of assignment of responsibilities. Focus on ‘service delivery’ performance rather than on existing institutions**
  - **Reassignment of government-owned property**
  - **Equalization transfers**
- **But what about:**
  - **Fee based service and user charges?**
  - **Local government-owned enterprises?**
  - **Local land and real estate markets?**



- Russia does not have an integrated housing policy that takes into account:
  - the very different needs of households and the units they occupy
  - The complementarities between maintaining/upgrading the decaying stock and the supply of new housing units
  - Government thinking in the HCS sector is still “communist/socialist” (Moscow UEI):
    - Square meters of housing that do not reflect the consumer value of a unit for HH
    - The artificial housing and community services “sector” that is completely separate from new housing supply.
    - Ignores the needs for trading and private reallocation of units among HH.
    -
- The basic distribution of the housing stock in 2004 is:
  1. 25% destitute HH (36 mn) below poverty line (< US120/months for a 3-person household)
  2. 35% poor and insecure HH(51 mn) can pay for food and clothing (< \$240/month)
  3. 35% low to upper middle-class HH(51 million) (between \$240/m and \$3,500/m)
  4. 5% of rich households (7 million) (> \$3,500/month for 3-person HH in provinces, and over \$7,000/months in Moscow and St Petersburg)



- The performance of housing and community services ‘sector’ is heavily influenced by the actions of local governments
- HCS budget single largest component of local government budgets (20% to 37%)
- Privatization of the housing stock has been severely flawed:
  - 70% of apartments were privatized, but not common areas, nor land under the building.
  - Much of enterprise stock transferred to local governments without maintenance funds.
  - Unfunded federal mandates based on unit size and privileges to designated HH (**I’goti**)
- Need to split the HCS system into two separate and distinct parts:
  - Joint-stock maintenance and management companies
  - Elimination of the unfunded federal system of housing privileges (L’GOTI)
  - Utility companies whose financial integrity must be established: raise tariffs to cover at least 100% of operating costs
  - Housing allowances for low-income HH must be integrated with a better safety net
- Putin administration “HCS sub-program” covers only part of the housing and local government reform needs (especially weak on subsidies)



- New housing construction driven only by highest HH income groups
- Sharply rising housing prices: deterioration of affordability continues
- Construction industry characterized by limited competition and low productivity (Mayor Luzhkov's wife owns largest building company in Moscow, and Russia)
- Constraints on the construction sector by local governments:
  - Urban planning and zoning
  - Permits and approval process
  - Land and property rights allocation
  - Overwhelming public ownership of land: even in St Peterburg only 8% of the land is privatized.



**CONCLUSION:**  
**WILL THE PUTIN ERA  
MEET SUCCEED?**