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**THE RUSSIAN HOUSING MARKET  
IN TRANSITION**

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## **ABSTRACT**

As late as 1991, the Soviet Union may have had the most regulated housing market in the world. For generations regulation had almost completely replaced formal market relations in the production and allocation of housing, although informal, implicit market relations had some role. In mid-1991, the USSR, and later the Russian Federation, began the daunting task of reorienting the housing sector to market principles. The potential gains of succeeding are enormous.

This paper inventories accomplishments to April 1993 in the housing reform program. They are perhaps surprisingly formidable, and certainly compare favorably with any country in Eastern Europe. To illustrate the magnitude of these accomplishments, the paper briefly reviews conditions at the beginning of the transition, discusses reform legislation and policies, and examines developments in housing construction, rental housing, and housing finance.

## EXECUTIVE SUMMARY

As late as 1991, the Soviet Union may have had the most regulated housing market in the world. For generations regulation had almost completely replaced formal market relations in the production and allocation of housing, although informal, implicit market relations had some role. In mid-1991, the USSR, and later the Russian Federation, began the daunting task of reorienting the housing sector to market principles. This paper inventories accomplishments to April 1993 in the housing reform program. They are perhaps surprisingly formidable, and certainly compare favorably with any country in Eastern Europe.

### ***Legal Developments***

The Russian Federation has succeeded in establishing the essential legal framework for the development of urban housing markets in the period since the enactment of the housing privatization law in July 1991. This is a major accomplishment. Of course, some of the necessary *codexes* and additional regulations consistent with the enabling legislation must still be produced. The major pieces of legislation passed by the Supreme Soviet included (informal titles):

Law on Housing Privatization, as amended (7/91 & 12/92)  
Law on Fundamentals of Federal Housing Policy (12/92)  
Law on Collateral (5/92)  
Law on Urban Planning (6/92)

A major law dealing with mortgage finance has been drafted and will shortly be introduced into the Supreme Soviet. The City of Moscow, under the provisions of the Law on Fundamentals, is about to issue the first decree governing condominiums.

Beyond the passage of laws, in August 1992 the Government of the Russian Federation assigned Minstroi the task of developing a comprehensive program for the reform of the housing sector along market lines. Minstroi (and later Gostroi<sup>1</sup>) took this task seriously, producing its first draft in November and a second draft in January 1993. It is clearly the most comprehensive policy statement available for the sector as a whole.

The program statement is largely an amplification of the contents of the major pieces of legislation already enacted, but it also outlines new policy initiatives. The statement was formally adopted by Government on March 18, 1993. It gives a clear indication of the direction intended for housing policy by some of the most important policy makers for the sector in the executive branch.

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<sup>1</sup> Minstroi (the Ministry for Architecture, Construction, Housing Facilities, and Communal Services) was downgraded in the fall of 1992 into two lesser organizations: the State Committee on Architecture and Construction (Gostroi) and the Committee on the Municipal Economy. The Chairman of Gostroi has cabinet rank.

## **Construction**

Housing production has fallen dramatically since the initiation of the economic reform program in 1990. Production levels in 1992 were about half of those in 1987. Within the smaller volume of production, state enterprises have emerged as the primary source of funding, with money from the federal government having been severely cut.

Even over the past two years there has been a distinct shift away from the traditional panelized construction. Official federal government policy is in favor of low-rise and cottage housing. Privatization is well underway, although the largest firms appear to be resistant. At the same time small, new private firms have increased their market share significantly. In short, there is every sign of a major restructuring of the residential construction industry in response to market signals and government policies.

## **State Rental Housing**

The magnitude of the state rental sector (67 percent of the national housing stock; 90 percent in the major cities) in the Russian Federation dwarfs the corresponding sectors in Eastern European countries; for example, in Hungary the state sector accounted for only 20 percent of the housing stock in 1989. The importance of state-owned housing—housing owned both by municipalities and by enterprises and government agencies (departmental housing)—means that any reorientation of the housing sector along market principles must begin with profound changes to this stock. Moreover, the fundamental problems of this sector would demand state-owned housing be given priority attention even if it constituted a smaller share of units.

The Russian Federation has adopted a two-track strategy for effecting this change: a maximum effort at privatizing this stock and reform of the pricing and delivery of services of those units that remain in the public inventory. There are four distinct aspects of this transition: privatization; the program of raising rents and introducing housing allowances; initial experiments in reforming the management of the existing stock; and, some special considerations involving department housing.

## **Privatization**

In one sense the privatization program is the *sine qua non* of housing reform in Russia: unless a significant volume of housing is in private hands, available for sales and rental in the market, there will be no market. Russian policy makers decided the gains from rapidly establishing a housing market (and giving a large number of families a direct stake in the overall economic reform program) outweighed the considerable costs which the policy of low-charge and no-charge privatization

entailed. These costs include the adverse distribution of the nation's wealth, i.e., those who had obtained the best units through positions of influence in the old system (i.e., the *apparatus*) now realize the largest windfall gains. Additionally, cities are denied the possibility of collecting substantial revenues badly needed for capital projects or even to fund housing maintenance.

Privatization really got underway in early 1992, and after a slow start has gathered very substantial momentum. During 1992 a total of 2.6 million units were privatized, with another 1.3 million applications pending. Of the total, about 55 percent were municipal units—about 15 percent of this stock. By contrast only about 5.2 percent of departmental housing was privatized, reflecting the widely held view that enterprises are discouraging tenants from privatizing their units. In the first two months of 1993, over one million more units were transferred to their occupants: the program is clearly obtaining its goal.

### ***Raising Rents and Implementing Housing Allowances***

While privatization is an important part of the story, it is far from the whole drama of reform of the state rental sector. According to survey results in Moscow, a substantial number of families interviewed said they are not interested or will definitely not privatize their unit. Directly changing the basis on which the rental sector operates is, therefore, essential.

Fundamental in this process is the dual policy of raising rents and introducing housing allowances (means-tested payments to low income families to assist them in paying rents). With higher rents, there will be enough income to fund good, competitive maintenance of the housing stock. Additionally, as rents rise to market levels, there will be no attraction to families who do not qualify for housing allowance payments to wait to be allocated a state unit. Similar units, whether private or state, will cost the same; why wait? The same, of course, will be true for those who do qualify for a housing allowance, i.e., they can find a unit they can afford with the allowance payment in the open market, they will be able to rent it. Consequently, over time as the supply of private rentals grows, the seemingly infinite waiting lists will simply quietly disappear, and along with them a major source of inequitable treatment and possible corruption.

The Law on Fundamentals mandates that rents in state housing be raised to cover full operating costs within five years, and it requires local governments to introduce housing allowances for social housing; they can provide them to other forms of housing as well. While a few cities raised rents modestly in 1992, the new rent increases will be of a different order of magnitude. The City of Moscow has received special permission, in principle, to proceed with implementing a program of rent increases and housing allowances before full federal guidance on the program is developed; however, as of April 10, the city is waiting for a final signature from

Prime Minister Chernomyrdin. Rents (fees for maintenance) will be increased ten times as soon as the final decree is issued, and housing allowances will be introduced in October when maintenance fees and charges for communal services are raised more dramatically. A draft Presidential Decree that will likely be issued in late April will order local governments to develop programs over the next three or four months.

Importantly, careful simulations for three cities—Moscow, Novosibirsk and Ufa—indicate that payments for housing allowances will generally be quite small compared with the total increase in revenues from raising rents. Thus, the program will not be a net drain on a city's resources.

### ***Housing Maintenance***

Maintenance of the housing stock in the Russian Federation is extremely bad. It suffers from a combination of underfunding and poorly performing maintenance companies. Each state maintenance firm enjoys a monopoly for the upkeep of several thousand units in a subdistrict of a city. In the absence of competition they have become badly motivated and provide little in the way of services. Data from a recent survey in Moscow on service interruptions (e.g., hot water, elevators, lights out in public spaces) and the responsiveness of these firms to requests for repairs from tenants constitute a virtual indictment of the firms.

Problems of motivation are compounded by reduced budgets. Charges for maintenance have generally been frozen at 1928 levels and tenant payments for communal services have not kept pace with inflation. This pattern compounded with the strained local budgets has led to systematic underfunding. One national estimate is that local governments are only funding maintenance at 25-30 percent of the funding level required for adequate services. While funding was never fully adequate, this figure represents a major deterioration.

Thus far the national government body responsible for building maintenance, the Committee on Municipal Economy, has taken no initiative to improve the situation. Pilot projects, organized with American assistance, have introduced private management to several thousand units in Moscow and Novosibirsk. The projects have attracted a good deal of attention from many cities who are anxious to improve maintenance. Nevertheless, the main hope for improved maintenance may be for the condominium associations that will be formed in buildings where a significant number of units have been privatized: in these buildings the tenants will control the firms hired and the quality of services received.

### ***Departmental Housing***

Departmental housing accounted for 44 percent of all urban housing in 1990 and 56 percent of state housing in urban areas. As enterprises come under increasing competitive pressure, they may wish to stop providing housing and other costly ancillary services to their workers and concentrate more on business. Consequently, they would want to shift as much of these responsibilities to municipal and other authorities.

The scattered information available does not support this hypothesis; rather, most firms seem to want to keep their housing on their balance sheets. In fairness, it should be noted that divestiture is not easy; local government often will not accept buildings offered to them because they do not have the funds to subsidize maintenance. The incentives to enterprises for maintaining their housing seem fairly weak; and the data available indicates that departmental housing is in worse condition than municipal housing.

Lastly, a salient issue is the future of the housing of privatized enterprises: the housing leaves the balance sheet of the privatized enterprise but the enterprise remains at least partially responsible, along with the municipality, for its maintenance. How this will work out in practice remains to be seen.

### ***Housing Finance***

Expanding long-term housing lending in Russia is a challenging task. The situation can be characterized simply as follows. While there has been limited housing lending, lending in which the housing asset serves formally as collateral did not exist (before the passage of the Law on Collateral in 1992). The banking system is embryonic and the creation of over 1,500 new commercial banks in the past two years has resulted in a poorly supervised and probably fragile system. High and volatile inflation rates imply potentially great interest rate risk for long-term lending, since the banking system's liabilities are heavily concentrated in short-term accounts. And, there is possibly grave credit risk associated with housing lending because the current confusion about the enforceability of foreclosure in case of default, despite existing legal provisions.

Government actions to encourage lending in 1992 took two paths. On the one hand, the Supreme Soviet passed the Law on Collateral, an essential piece of legislation, and made good progress on drafting the Law on Mortgage. On the other hand, it sought to insure the affordability of housing to middle income families through extremely deep interest rate subsidies administered by the country's unique housing lender, Sberbank. Some of these subsidies were on-budget, but the majority resulted from the repressed interest rate structure.

Despite these conditions, several major banks are highly interested in beginning mortgage lending operations on commercial terms. To facilitate these initiatives, the government must establish a regulatory and institutional framework which (a) reduces credit, interest rate, and liquidity and intermediation risks, and (b) separates subsidies for home purchase from regular loan operations. In the past few months some action has been taken to establish such a framework, most notably in the draft Presidential Decree, "On the Development and Implementation of Non Budget Forms of Investment in the Housing Sector," which was approved in principle at the March 18 cabinet meeting. The Government is pressing for mortgage lending to buoy the staggering construction industry.

The banking community has also been active. Sberbank and Mosbusinessbank, with American assistance, have designed a mortgage instrument that should work in Russia's difficult economic conditions. Several banks have sent staff to the U.S. and Europe for training in mortgage finance. An association of mortgage banks has just been created.

Taking these various actions as a group, there is genuine hope that mortgage lending on a financially responsible basis will begin in 1993.

## THE RUSSIAN HOUSING MARKET IN TRANSITION

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This paper inventories accomplishments in the housing reform program through April 1993. They are perhaps surprisingly formidable, and certainly compare favorably with any country in Eastern Europe. We begin by briefly reviewing conditions at the beginning of the transition in the balance of this introduction. Subsequent sections discuss reform legislation and policies and then developments, respectively, in housing construction, rental housing, and housing finance. The paper closes with some brief conclusions.

### ***Housing Sector Problems in Russia***

In general, it can be said that Russia has had a continuous housing crisis for many years. This is the result of a policy of "state paternalism" directed at maximum socialization of housing and the near-exclusion of market forces from the housing sector. The key principles of this policy were:

- centralized distribution of all resources and strictly formalized planning of the volume and distribution of new housing construction;
- use in practically all regions of the country of standardized multi-floor building construction plans, with housing constructed by a small number of big *kombinants*;
- extreme state monopolization of the construction complex and housing maintenance facilities;

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<sup>2</sup> Cited in Kahn and Peck (1991), Table 3.1.

- financing of all state housing construction exclusively from centralized assets of the state budget or of state-run enterprises;
- near-total subsidization of housing and maintenance organization activity through various forms of state funding;
- the constitutional guarantee of housing provision at a low cost (i.e., strong rent controls);
- the dominant role of a single, state-operated system for distribution of housing which operated through local waiting lists.

Thus, the goal of housing policy was almost completely directed toward the establishment and development of only one form of housing—state-owned units.

"Official" methods for resolving the housing problem boiled down to an endless line in which people waited to receive state housing. In fact, the manner in which the line was administered greatly contributed to the housing shortage because of the lack of incentives in the system for adjusting housing consumption. For example in old age larger units obtained during the child-rearing years are no longer needed, but there is no incentive to move to a smaller unit.

The Russian Federation currently occupies one of the lowest positions among developed nations in housing fulfillment, with an average of 16.7 square meters of total space for each occupant and an average of only 16.0 square meters in the cities in 1992.<sup>3</sup> According to data from the 1989 All-Union Census, only 83 percent of families and single persons in the RSFSR (previous name of the Russian Federation) had private dwellings—meaning a separate apartment, single-family house, or portion of a house. The rest of the population is forced to live in communal apartments or dormitories, or has no permanent home (see Table 0.1)

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<sup>3</sup> "Level of housing space provided" used to be the main indicator for establishing social norms, tabulating statistics, and making predictions.

Table 0.1 Percent Distribution of Families and Single People According to Dwelling Type			
	RSFSR	Urban Settlements	City of Moscow
All families and single people	100%	100%	100%
Those living in:			
Private (self-contained) apartments	56.7	65.1	77.2
Single-family houses	23.8	12.0	0.1
Communal apartments	6.8	8.7	15.5
Portions of houses	2.8	2.7	0.1
Dormitories	6.2	7.7	5.2
Other housing or sublets	1.4	1.4	0.1
Type of housing not indicated by respondents	2.3	2.4	1.8

**Source:** Based on data from the 1989 All-Union Census.

However, even these figures do not fully convey the real picture. They do not, for instance, reflect the natural desire of "complex families" (composed of several married couples and relatives of several generations) to live separately. According to our calculations, taking the desires of these families into account, the number of families and single persons lacking a private dwelling is at least 35 percent, and in the cities it is at least 45 percent.

The government-proposed solution to the housing problem led in the end to an increasingly longer line for the issuance of "free" housing, a line in which every fifth family is standing today. In 1986, 8 million were on the waiting list; 9 million in 1988; and 10 million families and individuals in 1992.<sup>4</sup> The system of distribution itself, which encouraged families to overstate their housing problems to the maximum degree, was a constant artificial stimulant for increasing *measured* housing shortage. Only households having living space of less than 5-7 square meters per person can receive the right to rent a new heavily subsidized municipally-owned flat. The standard space allocation is 12 square meters of living space per person.<sup>5</sup>

<sup>4</sup> Goskomstat of the Russian Federation, 1992c), Goskomstat of the RSFSR, 1991, p.213.

<sup>5</sup> On average, total space is about 150-160 percent of living space.

The housing shortage has increased in the past few years due to a catastrophic drop in housing construction brought about by overall economic collapse, a sharp reduction in state subsidies, and the sudden reduction in purchasing power of the population. In 1991, new housing construction was down 33 percent from what it was in 1987 (Goskomstat RSFSR, 1991). In 1992 it dropped 23 percent from 1991 (data from Gostroi of Russia).

Combined with the overall decline in volume of state housing construction, the move to sell the greater part of new housing sharply reduced the amount of housing available to those awaiting rental units. In the first quarter of 1992, only 67 percent of families receiving housing moved into new apartments, compared to figures from January to March of the previous year (Goskomstat, 1992). Meanwhile, in 1992 every fourth family in Russian cities was waiting for a state apartment, with an average wait for an apartment of seven to eight years.

The steps taken toward establishing a housing market, the extremely small number of apartments on the market, and the use of auctions as the main sales method have all led to astronomical prices. Market and auction prices for housing units in Moscow, for example, in 1991 were five to six times higher than the prices of new construction; in 1992 two to five times.

If the problem of the city dweller is the quantity of housing and the availability of separate units, the country resident is mainly concerned with the condition of the housing stock. Housing quality tends to have an inverse relation with the size and category of the population center. The state policy of industrialization and development of large urbanized industrial zones totally ignored the problems of forming an engineering infrastructure in the small cities and rural population centers. As a result, while 20 percent of public housing in cities and towns is without running water, sewerage, and central heating in the countryside, this figure is 55-60 percent of all apartments (Goskomstat of the Russian Federation, 1991, p.212).

A catastrophic situation has developed in the area of housing maintenance. In previous years, expenditures for maintaining state housing were paid for primarily by direct and indirect government subsidies. Because of almost complete elimination of these subsidies from the federal budget, redirection of part of the rents from commercial space to other uses, increased cost of building materials, and higher housing and utility labor costs, local budgets are not able to afford proper housing maintenance.

Rising energy costs have brought with them residential utility bills that increased three- to five-fold in January 1992. These costs doubled again between January and May and rose further in the fall. Actual energy costs during this period far outstripped what the population paid, necessitating increased subsidies. Without

fundamental change in the financing system for housing and utilities, particularly rent increases, it is highly unlikely that city budgets will be able to survive the approaching crisis.

The Russian housing stock is rather new: 89 percent of all dwellings have been built in the last 40 years (Center for Economic Forecasting, 1992, p.74). According to official statistics only 1.2 percent of the housing stock is dilapidated or condemned conditions (Goskomstat of the Russian Federation, 1992, p.111), and 7-9 percent according to the Gosroi of Russia data. However, the overall technical condition of the housing stock can be characterized as very bad. One indicator of this situation is that funds for capital repairs have consistently only provided for half of the repairs actually required (Goskomstat of the RSFSR, 1991, p.213).

State-oriented housing policy pursued in the country in past years gave rise to the overall housing crisis. Because of its importance, attention must be focused on reforming the state housing sector.

### ***Characteristics of the State Housing Sector***

One of the elements which sets the housing situation in Russia apart from other Eastern European countries is the nearly complete implementation of maximal government control of the housing sphere.

State housing represented 79 percent of housing in Russian cities in 1990, and 67 percent in the country as a whole (Table 0.2). Practically all the housing inventory in large cities is owned by the state. In Moscow, this accounts for 89.5 percent of housing; in St. Petersburg, 84.4 percent; in Ekaterinburg, 87.3 percent; and in Novosibirsk, 80.4 percent.

Forms of Housing Owned	Total Housing	Rural Housing	City Housing	Moscow
Total housing, including:	100%	100%	100%	100%
State, of which	67	37	79	90
Local council (municipal) funds	25	2	35	70
Enterprise and institution funds	42	35	44	20
Public, e.g., kolkhozs	3	9	1	0
Housing construction cooperatives	4	0	5	10
Owned by individual citizens	26	54	15	0

**Source:** Goskomstat RSFSR, 1991; Moscow City Council Bureau of Technical Inventory, 1991.

State housing property is not homogenous. According to the law (Housing Code of the RSFSR, 1991) "state housing was under the control of Local Councils of Peoples Deputies [Housing Fund of the Local Soviets] and the ministries, state committees and agencies [Departmental Housing Fund]." In 1990 the share of local soviets (municipal housing) within the state stock was 37 percent, with departmental units making up the balance. It is notable that the majority of state subsidies for housing came from the federal budget. Thus, in 1990, for example, subsidy from the local soviets for maintenance was only 5.7 percent of the total, including capital repairs. In Moscow, housing maintenance organizations actually showed a 27 percent profit (!) in the same year (USSR National Statistics Office, 1991, Table 1.3; Moscow Engineering Support Department data, 1992).<sup>6</sup> The management companies have an incentive to show a profit, even if funds are insufficient to provide decent maintenance, because special payments for vacations and "bonuses" come from profits.

Apartments in buildings that belong to the state housing stock are rented to citizens for an unlimited time. Establishment of legal limits on rents and housing privileges were the prerogative of the USSR Council of Ministers (Housing Code of the RSFSR, 1991). Rents that were established in 1928 at 13.2 kopecks a month per square meter and 16.5 kopecks a month per square meter for space in buildings with high levels of amenities, have remained unchanged. Thus, in 1990 rents constituted approximately 1 percent of income for a manual or office worker's family, and 2.5 percent if utilities are included. The remainder of funds for housing maintenance (80

<sup>6</sup> Not taking into account capital repair.

percent) came from state funds: 60 percent from the state budget and assets of state enterprises, and 20 percent from the income of housing and maintenance organizations including rents from commercial space. Communal services (utilities) were also subsidized at 80 to 90 percent.

The strategy of maximal socialization of the housing sector is also reflected in the extreme monopolization of housing maintenance by state, maintenance, repair, and construction services. Thus, for example, in Moscow the maintenance and continuing repair of municipal housing is carried out by 479 repair and maintenance boards. Each board employs 100 to 150 workers and serves 150,000 to 400,000 square meters of living space, with 8,000 to 25,000 tenants (Moscow Engineering Support Department, 1992). The established monopolistic structure clearly discouraged efficiency and initiative.

Renters of apartments in buildings that belong to the state housing stock have a very wide range of rights. There are practically no legal means (or at least none that are actually used) to evict them without providing them another residence. Until the end of 1992 there was no provision for eviction for not paying rent. Back rent owed by renters in the RSFSR is 10 percent of the yearly total (Goskomstat USSR, 1990). According to the latest data, back rent levels reached 40 percent in Moscow in the first quarter of 1990.

The first step of housing reform, the transfer of housing to municipalities and private owners, was seen as the most obvious, simple, and cheap means of improving the housing system. In accordance with the declaration, "On Delimitation of State Property in the Russian Federation," of 1991 and the subsequent Administration declaration of the same title in 1992, the state housing stock which earlier was controlled by the local Soviets, together with the corresponding infrastructure, housing maintenance and repair and construction organizations, was transferred to the municipalities. The housing stock of State enterprises and organizations (the "agency" housing stock) remained state property.

The transfer to the municipalities removed a burden from the federal budget and shifted responsibility for maintenance of the housing stock, and its construction and distribution, to local authorities. Unfortunately, this transfer took place in an environment of strict state control of rents and led to sharp increases in housing maintenance costs due to inflation. When subsidies from the federal budget almost completely disappeared, local budgets were not able to support the burden of maintaining the stock. In 1990 housing maintenance budgets covered only 60-70 percent of the required amounts, but by 1992 this share had declined to a mere 25-

30 percent.<sup>7</sup> As a result, a conflict began at the local level regarding the use of rent revenues from commercial space previously dedicated to housing maintenance.

The existing system of housing payment contributes to inequity within the "free" housing stock. Payment is based on the number of square meters of housing in an apartment; so the larger the apartment, the greater the subsidy. And higher income (where income includes both cash and in-kind payments) households do live in larger housing. Thus, state housing subsidies are higher for higher income families.

Families living in housing cooperatives and privately owned individual houses will in the end have to pay for most capital and maintenance costs, which according to our calculations (based on 1990 data) will be seven to eight times higher than similar costs for people living in state housing. Studies also show that those in state housing are not in the lowest income group. Rather, it is their social status that has gained these people access to free housing. Thus, in spite of the customary propaganda about Russia's having the cheapest housing in the world, the 30 percent of the Russian population in coops and individual houses is paying nearly the full price for housing, without having any greater freedom of choice than those living in free state housing.

### **Personal and Cooperative Housing**

About 26 percent of the housing stock in Russia is the personal property of individual, often referred to as "individual housing." In urban areas it makes up 15 percent of the stock and in rural areas 54 percent. Prolonged prohibitions on individual housing construction in cities of over 100,000 population, as well as universal difficulties in obtaining land plots, in buying building materials, and in securing loans virtually halted construction. Consequently, individual housing accounted for only 5-6 percent of new construction. This stock was often not equipped with communal services—about two-thirds of the units lack piped water, sewerage, and hot water heat—and has nothing in common with modern single-family housing.

In addition, ownership rights were limited. First, without the possibility to sell and purchase land, plots were allocated by local soviets in accordance with waiting lists. One could not be placed on such a list without the special residential permit (*propiska*). Second, according to the housing laws of the RSFSR, individual housing could not be exchanged, i.e., swapped, until recently for a state-owned dwellings. Important in the cities, this had little effect in rural areas where state housing construction was negligible.

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<sup>7</sup> According to data from the Program HOUSING (described in the next section), prepared by Gostrol and the Ministry of Economy.

There were also restrictions on the right to rent private houses. Private rents could not be more than the rent in the state rental sector, i.e., more than 16 kopeks per square meter of living space per month. If higher rents were charged and the owner was caught, the property could be seized by the state, according to the "housing codex."

In the early 1960s house-building cooperatives began to develop. They are concentrated in urban areas and constitute about 4 percent of the housing stock. Under cooperative ownership, the flat is considered the collective property of all the members of the co-op. Until recently the rights of any member were limited to receiving the cash payment of his contributions to the co-op upon leaving it. The rights of the cooperative as a collective body were also limited and were regulated by normatives. Cooperative membership was not connected with the desire of joint living of some socially connected group of people. Membership was restricted to those who had less than an established norm (8-9 sq.m. of living space per person). The location, unit sizes, and design were all regulated by government bodies. Separate waiting lists were maintained for cooperatives, and families were often on municipal, departmental, and cooperative waiting lists. The volume of construction was determined by the state planning agency.

In late 1988 the first steps in privatizing housing were made: flats whose owners had fully paid their share of the funds borrowed to build the co-op were made the property of their owners.<sup>8</sup>

We now turn to Russia's record in trying to dismantle the endless web of regulation governing the sector.

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<sup>8</sup> "On Measures to Accelerate the Growth of the Housing Cooperative Movement." Resolution of the CPSU Central Committee and the USSR Council of Ministers of March 31, 1988, no. 406; published in SP SSSR [Collection of Resolutions of the USSR], 1988, no. 16.

## **LEGAL AND BROAD POLICY DEVELOPMENTS**

Since the summer of 1991 the Russian Federation has moved with alacrity to establish the basic legal framework for a market oriented housing sector. This section reviews the major pieces of legislation, as well as the major policy statement based on this corpus of legislation. Taken as a whole they represent an impressive accomplishment. Naturally, when legislation is enacted at this speed and responsibility is divided both among numerous committees of the Supreme Soviet with imperfect coordination and between the legislative and executive branches, some defects will be present. These can be remedied; more important is that a solid, basic structure has been established upon which one can build.

Laws and the policy statement are summarized individually in this section. In later sections the provisions most important for certain aspects of housing reform are drawn from the various laws to provide an alternative perspective.

Before examining specific legal developments two characteristics of housing law are worth noting. First, housing policy is defined in the treaties between the Russian Federation and the constituent republics, krajs, oblasts, autonomous subdivisions of the Russian Federation and the autonomous municipalities of Moscow and St. Petersburg to be under the joint jurisdiction of the Federation and these lower level governments. (Often in the balance of the paper we refer to these lower governments collectively as "republican governments.") This means that the Russian Federation passes broad enabling legislation and then the subordinate governments enact their own measures to implement the general provisions, through the adoption of both legislation and regulations.<sup>9</sup> In some cases, such as the law privatizing housing, implementing legislation is needed at the lower levels.

Second, even at the Federation level, legislation is sometimes two-tiered. The first law will be a broad enabling act. This will later be elaborated upon in a subsequent act, often called a "codex." Many countries handle this type of refinement through the issuance of regulations by the responsible ministry. In Russia, however, both options are available; and the codex is generally chosen as the vehicle for legislation that defines the whole policy structure for a sector.

### ***Constitutional Amendments***

The Seventh Congress of People's Deputies, convened in December 1992, passed two amendments to the Constitution of the Russian Federation critical for housing reform.

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<sup>9</sup> In these attributes the allocation of responsibility resembles that in the Federal Republic of Germany and Canada.

Article 58, dealing with the *rights of citizens to housing* at a low price, was replaced with a much more market-oriented variant. In part, the new article states that the State's obligation to provide housing can be satisfied by the household's purchase or construction of housing at its own expense, the provision of housing through the *naym* (social housing) contract, through payments of housing allowances, or subsidies for construction, maintenance or rehabilitation of housing.

The amendment to Article 12, part 3, removes the restrictions on the right in the housing sector to freely possess, use and dispose of *land plots owned by individuals*. This amendment strikes down important restrictions on sales, including a substantial waiting period before the land can be sold after it is obtained—a provision designed to thwart speculation. Note, however, that even under this amendment land can only be sold completely without restriction if the use of land remains residential.

### **Housing Privatization**

This law—officially, "On the Privatization of the Housing Stock in the Russian Federation"—appears in retrospect to have been perhaps the key policy initiative in the sector. Its passage in July 1991 might be taken as initiating a policy of a significant shift to a housing sector operating on market principles. Importantly, the law built directly on previous legislation and the ideas put forth in the preceding months by several cities (Kosareva and Struyk, 1993).

Under the law tenants of municipal and department housing (housing belonging to enterprises and government departments) have the right to purchase their unit. The main features of the July law are the following:

- Only tenants officially registered as the occupants of the flat can purchase the unit.
- The tenant is given, in effect, a voucher free of charge. The value of the voucher is the price of one square meter of an average quality unit in the city in which the tenant lives times the number of square meters to which he is entitled. The entitlement is computed as 18 square meters of usable living area per person plus an extra 9 square meters for the households.
- The tenant pays the difference between the assessed value of the unit and the value of the voucher. Families living in a unit with a value less than the voucher receive no additional compensation.
- Those living in cooperative projects and in individual houses do not receive a voucher.

- During the transition period (length not specified), the old system for allocating units remains in effect. Those allocated a unit have the right to purchase it under the same conditions as listed above.
- Each family can only purchase a single unit under the privatization procedures.
- Some types of buildings cannot be privatized: those which are below the sanitary norms or are dangerous to inhabit, flats with shared kitchens and toilet facilities, and buildings of historical and cultural significance.

Within these provisions considerable freedom was given to local governments. They could, for example, increase the amount of space to be given without charge. Also, they ultimately determine the procedure for valuing the average square meter of housing in their locality and differences in values with housing quality levels. Local governments could, in addition, override the RSFSR law to permit some types of units on the prohibited list to be privatized. Indeed, the RSFSR law was written in such a way that local legislation was required for its implementation; and the time elapsed until such legislation was passed—often six months or more—significantly delayed program implementation.

The law was amended in December 1992, ostensibly to accelerate the privatization rate. The most far-reaching change was to make free-of-charge privatization mandatory, i.e., the whole idea of implicitly giving tenants a voucher was eliminated. While a few regions and cities, most notably Moscow, had embraced free-of-charge privatization from the start, these cases were exceptional. This shift obviously created a serious equity issue between those who had already privatized and paid something for their unit and those later privatizing similar units.<sup>10</sup> The law is silent on whether those acting earlier should receive any compensation, and there are no reports to date of any government paying such compensation.<sup>11</sup>

### ***Regulations on Condominiums***

A significant limitation of the privatization law is that it does not deal effectively with the creation of condominium or other forms of homeowner associations for buildings in which some or all units are privatized. Therefore, the situation in Russia differs fundamentally from that in Hungary, for example. There,

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<sup>10</sup> In fact only a modest share of those privatizing made payments; see section 3 for details.

<sup>11</sup> The law also specifies that the state maintenance companies are to continue maintaining the buildings, seemingly limiting the ability of the new owners to select their own company. This provision is in conflict with provisions in the Law on Fundamentals of Housing Policy (see below), and no clarification has yet been made as to which provision prevails.

tenants of a certain share of units in a building must state that they will privatize their units before anyone can privatize (35-50 percent of units); and the necessary legal steps must be taken to create a condominium association *before* title to the first unit is actually transferred to the new owner. In Russia, there is no minimum share of units requirement and the creation of homeowners associations were left entirely up to the new owners.<sup>12</sup>

The effect of this oversight was to deny the new owners some of the most important benefits of ownership: the ability to control the quality of maintenance services and the type and extent of renovation to the building.<sup>13</sup> As the volume of privatization increased, the urgency for addressing the omission of law explicitly dealing with condominiums became acute. For one thing, no bank would lend for the purchase of a privatized unit because the credit risk was simply too great owing to the lack of any provisions for the building to be adequately insured or maintained.

As discussed below, the Law on Fundamentals of Housing Policy in the Russian Federation contains a very general provision permitting the creation of condominium associations. Given this provision it was determined that republican level governments had the authority to create regulations for the creation of condominiums, even though the Russian Federation would also issue general regulations on them. In this context the Government of Moscow, with U.S. technical assistance, prepared regulations on condominium associations.<sup>14</sup> At the end of March 1993, Mayor Yuri Luzhkov signed a Decree of the City of Moscow which created the first detailed regulations for this type of housing. The Moscow regulations are expected to serve as a model for a Presidential Decree on condominiums and the relevant sections on the codex that will implement the Law on Fundamentals.

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<sup>12</sup> To be completely accurate, the regulations on housing privatization promulgated by the Council of Ministers in the fall of 1991 did contain an annex that provided a simple form allowing for the creation of the an owners association. But the document was essentially silent on the benefits that could accrue to the new owners from creating such an entity.

<sup>13</sup> The legal situation regarding the rights of owners of flats in a multifamily building were in fact even more confused. The amendments to the privatization act stated that the existing state maintenance organizations would continue to maintain the common spaces (which according to the amendments could the property of unit owners or users of the common space, i.e., renters as well). At the same time unit owners could engage other firms to maintain their own dwellings. However, the Law on Fundamentals which was passed on the following day contradicted this law by directly stating that a condominium association could select its own management company (Article 8).

<sup>14</sup> "Basic Principles for Formation and Activities of Communities of Residential Unit Owners Intended to Manage the Housing Stock Subject to Joint Ownership (Housing Communities)."

### ***Law on Fundamentals of Federal Housing Policy***

The Law on Fundamentals may well be the most comprehensive and progressive major reform law enacted in Eastern Europe by the end of 1992. Its enactment at the end of December 1992 was paved by the passage of the key constitutional amendments earlier that month previously noted.

The law covers a number of areas. Especially important provisions include the following:

- The concept of real estate is clearly defined, and the rights of ownership of housing without limit is definitively clarified.
- Local governments are required to provide individuals and developers with plots of lands for housing construction within one month and two months, respectively, on terms to be determined by the local government; plots are to be provided within the framework of local urban plans (see Law on Urban Development, below).
- Enabling provisions for condominiums are included.
- In the social rental sector, the law
  - requires that republics, krais, oblasts and autonomous subdivisions and the autonomous municipalities of Moscow and St. Petersburg [herein called "republican governments"] set fees for maintenance and payments for communal services so that they at least fully cover costs within five years;
  - requires republican governments to create housing allowances for the social housing stock<sup>15</sup> and permits them to create them for other types of housing;
  - requires republican governments to set the social norm for housing, i.e., the size of unit which families of different sizes are entitled;
  - permits swaps of units without limitation;
  - provides for eviction to housing meeting "dormitory standards" for those not making rental payments for six months (following a court procedure).

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<sup>15</sup> The Law states that the "Housing of social use is formed by local authorities out of state, municipal, and public housing stock provided publicly by state and municipal enterprises, institutions and public associations" (Article 12).

- permits republican governments to rent any share of the municipal housing it chooses under a standard rent agreement (as opposed to the social rental or *naym* contract).
- There is no control on rents of privately owned units.
- Competition in the procurement by state bodies of maintenance services, rehabilitation and new construction of housing is to be the rule.
- Citizens are given the right to obtain mortgage finance for housing acquisition; the law specifies that loans can be guaranteed by government bodies.

This law is in the form of enabling legislation, i.e., it is designed to provide a general framework to be filled in by a more specifically regulatory and clarifying law or a "codex," to use the Russian term. This codex is now under preparation. Yet, some republican governments, particularly Moscow, are not waiting for the codex. Moscow and Nizhni-Novgorod petitioned the Federation Government to implement their housing allowance schemes as experiments. And Moscow has issued its decree on condominiums.

### **Laws on Collateral and Mortgage<sup>16</sup>**

The law governing mortgage lending is complex. In effect, the Laws on Collateral and Mortgage perfect provisions of the Civil Code, which deals with private commercial transactions.<sup>17</sup> Therefore, provisions of the laws specific to mortgage lending must be read with and understood in the context of the Civil Code. The Civil Code in particular details the procedures to be followed in enforcing the contract in case of default on the loan.

The Law on Collateral was passed by the Supreme Soviet in May 1992; the Law on Mortgage is under preparation by the Supreme Soviet and is likely to be introduced directly.

The Law on Collateral (LoC) is a statement of the general legal principles of security arrangements. It addresses other types of security agreements in addition

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<sup>16</sup> This section draws heavily on Butler (1993).

<sup>17</sup> There are several laws governing private commercial transactions in Russia: (1) the Fundamentals of Civil Legislation of the USSR and the Republics, May 31, 1991 ("Fundamentals of Civil Legislation"; the Civil Code of the Russian Soviet Federative Socialist Republic, June 11, 1964, as amended (the "Civil Code"); and the Code of Civil Procedure of the RSFSR, June 11, 1964, as amended (the "Code of Civil Procedure"). For an explanation of the role of these various laws in this context, see Butler (1993), pp. 5-9. In the discussion in the text, this corpus of law is simply referred to as the "Civil Code."

to real estate, including, for example, pawn. The LoC states that property subject to mortgage includes any property that an eligible mortgagor has the legal right to alienate. The major exception to this statement is that mortgages on land are to be governed by other laws of the Russian Federation. The LoC carries out several tasks:

- the form of the mortgage is specified, including registration requirements;
- the rights and obligations of the parties are defined; and
- provisions for enforcement of the contract and priorities for obtaining receipts from a foreclosure sale are stated.

Butler's (1993) statement succinctly summarizes the legal situation for mortgage lending after the enactment of the Law on Collateral:

The existing Russian law of real estate mortgages...can be marginally effective in its present stage of development. Much, of course, remains to be seen in how the laws are interpreted and enforced as the volume of residential mortgage lending increases. But the laws themselves give creditors and debtors a relatively clear picture of their rights and obligations provide a rational, though largely untested, system for enforcement of security rights in real estate; and attempt to strike a balance between the rights of debtors and creditors. (p.31)

Butler goes on to list a dozen areas in which the law could be clarified and strengthened to deal with existing weaknesses.

The Law on Mortgage (LoM) was designed to refine the provisions of Law on Collateral with respect to mortgage lending. The relevant committee of the Supreme Soviet has obtained expert Russian and U.S. advice in drafting the LoM and convened a working group that includes commercial bankers to help draft the law. Some of the important clarifications in the draft law include the following:

- Provisions dealing with the assignability of mortgage security, and clarification that assignment is only valid in connection with assignment of the underlying debt.
- Provision for a nonjudicial process of mortgage foreclosure as well as for a negotiated deed-in-lieu of foreclosure.
- Variable rate and negative amortization loans have been dealt with by allowing attachment of a mortgage schedule setting out formulas for calculation of the interest rate, outstanding debt, and other variable sums.

- The law adopts its own rules for foreclosure auction sales. While they follow closely those of the existing law of Civil Procedure, there was a question as to whether the existing law applied to real estate foreclosures.
- Issuance of bank securities or bonds secured by mortgages is specifically addressed.
- Mortgagees have been given priority liens on condemnation proceeds.
- The status of mortgages on apartments in commonly owned buildings as "real estate" is clarified.

While a number of provisions in the draft law could be improved,<sup>18</sup> even in its current form, the Law on Mortgages would provide very substantial improvement in the legal basis for mortgage lending.

### ***Law on Fundamentals of Urban Planning***

This law, enacted in July 1992, is to urban planning policy as the Law on the Fundamentals of Housing Policy is to housing policy—a broad enabling act. Like the Law on Fundamentals of Housing Policy, it is to be filled in through enactment of a codex by the Supreme Soviet and by laws passed by the constituent "republics."

The law is dominated by a "master plan" perspective. Such plans are to be produced for all urban areas, and plans are required for successively lower administrative districts within a region. The master plan for a city is

the basic juridical document that defines ... the prerequisites for habitation, the directions and bounds of area development, functional zones, the development and provisioning [sic] of amenities and services for the region, and preservation of historical, cultural and natural heritage (Article 6(4)).

A developer is to have full range of choice on how to develop a project, provided that the project falls within the master plan.

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<sup>18</sup> These are listed in Butler (1993a). Among these are the following: some ambiguity regarding the circumstances under which a mortgage is terminated; some basic issues about priorities of liens, in particular the issues of construction loans and other loans disbursed in installments; the board discretion give to courts to defer satisfaction of the debt or restructure the loan if there is a land parcel involved in the transaction; discretion of the court to stay execution of a mortgage foreclosure; ambiguity on acceleration of debts in default; and the absence of requirements for consumer protection through disclosure.

The law prominently cites that citizens and their associations and other nongovernmental organizations are to be active participants and partners along with government in the planning process. However, no public hearing process is mandated and the review of proposals is to be executed by expert consultants and officials.

But until the codex is developed and passed into law, it is very difficult to guess the actual guidance for the execution of the law's various provisions.

### ***The Program HOUSING***

In August 1992 the Government of the Russian Federation assigned Minstroi the task of developing a comprehensive program for the reform of the housing sector along market lines.<sup>19</sup> Minstroi (and later Gostroi<sup>20</sup>) took this task seriously, producing its first draft in November and a second draft in January 1993. It is clearly the most comprehensive policy statement available for the sector as a whole.

The program statement is largely an amplification of the contents of the major pieces of legislation already enacted, but it also outlines new policy initiatives. The statement was formally adopted by the Government on March 18, 1993. It gives a clear indication of the direction intended for housing policy by some of the most important policy makers for the sector in the executive branch.

A summary of the initiatives contained in the program is given in Box 1.1. Most of these are elaborations of existing legislation, but some, such as the creation of a new housing development fund (listed under housing finance) are new. The program also calls for a major shift in housing production, away from heavy panel buildings and to single-family, or "cottage housing" in the Russian vernacular. Many of the provisions in the Program will require Presidential Decrees or government regulations to implement. It is far from certain that the more specific proposals will be accepted in their present form.

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<sup>19</sup> Resolution no. 602, "On Measures for Realization of the Economic Reforms Intensification Program."

<sup>20</sup> Minstroi (the Ministry for Architecture, Construction, Housing Facilities, and Communal Services) was downgraded in the fall of 1992 into two lesser organizations: the State Committee on Architecture and Construction (Gostroi) and the Committee on the Municipal Economy. The Chairman of Gostroi has cabinet rank.

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**Box 1.1**  
**Summary of Suggested Initiatives in the Program HOUSING**

Housing privatization

- To allow the transfer of land plots on which individual units are constructed when the unit is privatized, up to 150 to 200 square meters per person.
- To accelerate the process of privatization by announcing a limit to the time for privatization on preferential terms.

Treatment of families on the waiting list for improved housing

- Give families on such lists the opportunity of receiving a subsidy to leave the waiting list and obtain housing for themselves; the size of the subsidy would depend on such factors as the time waiting and the size of unit for which the family qualifies. The form of the subsidy is not specified.

Elaboration of the housing allowance program

- Guidelines are given for the five year transition period for the share of income renters should be required to pay for housing in order to obtain a housing allowance; guidelines are also given for the share of total operating costs that should be covered.
- It sets the eventual goal of having rents in state housing set by the market.
- Cash increments, through increased wages or grants, are proposed to help offset the increased rent burden of families.
- Allowances are suggested to be "paid" as reductions in rent due, rather than cash payments to the renter who would then pay the landlord.

Housing finance

- The expansion in the availability of housing finance is stressed as fundamental to reducing state support of housing construction.
- Different degrees of subsidies are proposed for households in different economic circumstances, with the highest income receiving none.
- A contract savings scheme is proposed.
- Various subsidy mechanisms, including assistance with downpayments, are suggested.
- Creation of the Housing Construction and Municipal Economy Development Fund, which would draw sources from a number of sources and then provide them for various housing investments, including development of building materials companies, construction of social housing, and development of residential infrastructure.

Tax incentives for housing

- The total amount of such expenditures would be limited by annual budgetary action.
- Several deductions are proposed, including exemption of dividends and shares of firms investing in the housing sector.

Policy Development

- Creation of a cabinet-level Coordination Board to oversee reform in the sector.
  - Restoration of housing to a ministry-level agency and creation of a policy development office within it.
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The Program HOUSING represents a considerable amplification and refinement of the policy directions established in the various laws passed in the last twenty months. On the other hand, the lack of quantitative estimates, particularly of the budgetary implications of the various proposals for increased housing production, is striking. Many of these proposals would be extremely costly. The principal theme is clear: build housing. But the document fails to set forth whether the primary goal is to maximize production, which would imply shallow subsidies to those just unable to afford to purchase a new unit, or to maximize production for the middle class, which entails much deeper subsidies and consequently fewer units. The production maximization goal is consistent with using housing as a countercyclical macroeconomic tool and to assist the *kombinants* to continue operations long enough to restructure. But it is extremely difficult for the Government to make such decisions well without more information than is presented in the Program.

**Conclusion**

The Russian Federation has succeeded in establishing the essential legal framework for the development of urban housing markets in the period since the enactment of the housing privatization law in July 1991. This is a major accomplishment. Of course, some of the necessary codexes and additional regulations consistent with the enabling legislation must still be produced.

The challenge now is to move to implementation. At this stage there must be more precise analysis and legal and regulatory definitions. The regulations will likely be forthcoming. There is greater concern, however, about the analysis that will guide spending and taxing decisions. Unfortunately, this lack of hard analysis has been a general characteristic of the policy development process in the sector.

**RESIDENTIAL CONSTRUCTION**

The essential elements of the previous policy on housing construction were: centralized distribution of capital resources; strict standardization in the planning of the volume of housing made available and of its distribution in the country; extreme monopolization of the construction industry by the state, primarily in the form of large construction enterprises (so-called *kombinats*). As a result, the same large multi-story buildings of precast reinforced concrete were constructed in all regions of the country. The only variety introduced in 35 years was four generations of design standards for these building plans. The state had the monopoly position and acted as the investor, client, contractor and owner at the same time.

As seen in Table 2.1, which shows the volume of housing construction according to client, the main share of housing construction (no less than 80 percent up until 1991) was in the state sector. The remainder was individual construction (7.5 percent in 1990), construction by collective farms and public organizations (7.5 percent), and housing cooperative construction (5 percent).

Year	1980	1985	1988	1989	1990	1991
Total	1,190	1,151	1,287	1,221	1,044	751
State enterprises and organizations	997	921			835	568
Housing cooperatives	52	82	1,148	1,082	52	41
Public organizations, etc.	8	10			31	47
Private persons	72	56	77	84	79	61
Collective farms	61	82	62	55	47	34

**Sources:** Goskomstat of Russia, *The Russian Federation in Numbers*; Goskomstat of the RSFSR, *The RSFSR Economy for 1990*.

**Trends in Construction**

The trend in housing construction can be tracked with three indicators: units built per 10,000 population, total square meters, and investment expenditures. The scale of the construction in previous stable situation was about 80-90 dwelling units per 10,000 persons of the population (93.5 in 1988). Then the crisis in the housing sector, which was the first immediate result of the general economic reform, reduced

the number of apartments constructed per 10,000 persons: in 1990 - 70.3, in 1991 - 50.5 (54 percent of the 1988 level).

The high point of housing construction was reached after two years of the "Housing 2000" program, which mobilized state budget funds for housing to produce 72.8 million square meters of overall housing space in 1987. After 1987 production volume fell off sharply: in 1991 only 49.4 million square meters were completed and in 1992, 37.9 million square meters—only 52 percent of 1987 level.

Finally, total investments in housing from all sources displays the same pattern. In 1990 housing investment was 205.3 billion rubles; in 1991 it was only 89 percent of the previous year level; and in 1992 only 49 percent of the 1990 level.<sup>21</sup>

In short, current housing construction is marked by a sharp reduction in all forms of housing and financing of housing starts (Table 2.2), although for construction of individual houses this process began with some lag only in 1991. The main reasons for this reduction are: (1) the dislocation in the former organizational and institutional system for housing development during the economic transition period; (2) the general investment collapse in this period; (3) a sharp absolute reduction in central state investments in housing sector; and, (4) the decline in demand side due to increases in construction costs relative to incomes.

	1987	1988	1989	1990	1991	1992
Total housing introduced	100	99	97	85	66	52
State capital and enterprise investments	100	98	95	80	60	44
Individual citizens	100	124	140	143	112	102
Housing cooperatives	100	100	90	71	59	24

**Sources:** Goskomstat Russia, *The Russian Federation in Numbers*; and data from the Ministry of the Economy and Gostroi of Russia.

<sup>21</sup> Calculations of Ministry of Economy in 1991 prices.

### **Prices**

Price increases for construction have been in line with those of the rest of the economy. In 1985 the construction cost of one square meter of a multi-family, multi-story, large-panel building built with the state capital investments was about 260 rubles, in 1990 - about 320 rubles, in 1991 - about 800-1000 rubles. Estimates from Gostroi and Ministry of Economy of Russia for 1992 are 16.1 thousand rubles, and the forecast for 1993 is 50-60 thousand rubles. These costs are different in different regions and cities. For example, in 1992 in the Central Region it was 14.55 thousand rubles, in the Far-East Region - 27.5 thousand rubles, and in Moscow - 50 thousand rubles (in December of 1992 it increased to 90 thousand rubles).

According to these statistics, the price increase in this construction area was at least 1,510 percent for 1992, while the increase for the previous seven years combined (1984-1991) was only 400 percent (Center for Economic Conditions and Forecasting, 1992).

### **Financing**

The main sources for financing housing construction have always been centralized state capital investment distributed between the budgets of local governments and enterprises, and investment by enterprises from their own funds (Table 2.3). In 1987, the year in which some real attempt was made to begin the state housing program, the share of central state investments was 78 percent. Then the centralized funds began to fall. Now with macroeconomic reform policy of reducing the budget deficit, the federal budget is used mainly for construction of houses for resigned military officers, refugees, persons living in the Far North Region, and for victims of the disaster at Chernobyl. According to the estimates of Gostroi and the Ministry of Economy (Program HOUSING), in 1992 only 14 percent of all investments for housing construction was made from the federal budget.

<b>Table 2.3</b> <b>The Structure of Capital Investment for</b> <b>Housing Construction, 1987-1991</b> (percent distribution)					
funding source	1987	1988	1989	1990	1991
total investment	100	100	100	100	100
central gov't funds	78	42	38	37	30
funds of enterprises	7	42	46	46	50
housing construction cooperatives	4	4	3	3	3
collective farms	7	7	7	6	5
population	3	4	5	5	6
public organizations	1	1	1	1	1
other sources	0	0	0	2	5

**Source:** Goskomstat of Russia.

The task of providing units to families on the waiting lists for housing has become completely the responsibility of local authorities, which do not have budget resources for this purpose. According to government estimates (Program HOUSING), in 1992 housing investment from the local budgets consisted of only 9 percent of the total. Cities could only sustain production with extraordinary actions. For example, in Moscow—maybe the only city in which the level of housing construction in 1992 was not reduced compared with 1991 (3 million square meters constructed)—the municipality used a unique Central Bank loan and sold about 10 percent of the units constructed at auction to finance construction.

The dynamics of housing construction funded by state and municipal enterprises can be explained in the following way. In the former, centralized system the enterprises constructed residential buildings using mainly the state distributed funds: in 1987 their share of investments was only 7 percent. But, during the first years of the economic reform, policies permitted them to pile redundant resources in so called "funds for social development of enterprises;" these funds could not be used for wage increases because of wage controls. The enterprises began to invest these funds in housing construction. In 1988-1989 this increased building activity was particularly evident, and the share of enterprises' investments reached 46 percent of total housing construction investment.

But after 1989 the economic and regulatory situation changed and the enterprises preferred to use these funds to increase wages. Today enterprises, both state and private, remain the main investor in housing: their share in 1992 was 56 percent (estimates from Program HOUSING). According to Goskomstat data for 1992, 72 percent of all housing construction was done through state enterprises and organizations (using both central capital investment funds and their own funds).

To stimulate investment, beginning in 1993 all kinds of investments are deductible from the profits tax. But it is difficult to predict whether housing investments will be a main priority of the enterprises. The chief problems are the significant increase in the price of construction and the declining resources of many enterprises.

Production of individual housing has increased in recent years (from 1988) because of the removal of the ban on construction of such units in the large cities, a relative reduction in the red tape in land allocation, and the possibility of receiving land as personal property for constructing a single-family house. However, the sharp reduction in the purchasing power of the population—due to the freeing of prices, increased inflation, and reduction in the level of real income—has had a negative effect on this portion of housing construction since 1991.

### **Industry Dynamics**

Under the centralized planned economy in Russia, a powerful state construction industry produced building materials for annual construction of up to 70-75 million square meters of housing, including over 40 million square meters in large-panel structures. In 1992 in Russia there were 218 huge *kombinats* with average capacity to produce the prefabricated construction materials and to build 127 thousand square meters of total housing space. These *kombinats* constituted only 1 percent of all contractor construction organizations in 1992.

In addition there were 73 enterprises with capacity only to produce large-panel construction elements; each can produce 152 thousand square meters annually. There are also 127 subdivisions within the other enterprises with the same purpose but somewhat less capacity. The result of this industrial capacity was that in recent years over 50-55 percent of the total volume of housing construction in Russia is erected from precast, reinforced concrete.

A disastrous situation has emerged in the construction industry because of the sharp reduction in capital investment for housing from all sources. In 1992 the volume of construction work done by contractors fell by 36 percent in comparison with the already low 1991 level [Goskomstat of Russia, 1993]. Large state building enterprises are in a state of crisis today. With increasing costs of inputs approaching real market prices, the large multi-floor panel construction buildings, produced by

these enterprises, have become the most expensive housing produced and extremely unprofitable. Since this part of the industry of construction materials has not been very successful in changing its approach, it is now working below capacity. According to Ministry of Economy of Russia figures for 1992, large panel construction used only 36 percent of its capacity but was still 45 percent of all housing construction.

The main construction strategy outlined in the Program HOUSING is the significant reduction in the production of traditional forms of housing construction, the conversion of the capacity of precast reinforced concrete plants to social buildings, and the development of low density and cottage construction.

The process of privatizing and demonopolizing the construction industry is moving quiet fast. It is reportedly one of the two fastest privatizing sectors.<sup>22</sup> According to estimates of Ministry of Economy of Russia in 1992 about 25 percent of state construction enterprises were privatized and another 20 percent are in the formal planning stage. (These figures exclude municipal firms.)

The government still owns most of the available capacity. Forty-nine percent of new housing construction for 1992 was performed by large government construction firms, with 21 percent by leasehold organizations, 22 percent by joint-stock companies and 5 percent by cooperative enterprises [Goskomstat of Russia, 1993]. At present, joint-stock housing construction is showing the greatest production viability. In just the first nine months of 1992, the share of houses completed by joint-stock enterprises rose from 2 percent to 11 percent.

The demonopolization of the large construction enterprises is underway in the form of separation of some kind of activities and some subdivisions. The early, small cooperatives, private companies, and joint ventures in housing construction have spent the first brief interval fulfilling the needs of the highest income population group. They are now encountering a reduction in demand caused by an underdeveloped system of housing finance for consumers.

### **Conclusion**

Housing production has fallen dramatically since the initiation of the economic reform program in 1990. Production levels in 1992 were about half of those in 1987. Within the smaller volume of production, state enterprises have emerged as the primary source of funding, with money from the federal government having been severely cut.

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<sup>22</sup> Interview with Jonathan Hay, USAID consultant in the State Property Committee of Russia.

Even over the past two years there has been a distinct shift away from the traditional panelized construction. Official federal government policy is in favor of low-rise and cottage housing. Privatization is well underway, although the largest firms appear to be resistant. At the same time small, new private firms have increased their market share significantly. In short, there is every sign of a major restructuring of the residential construction industry in response to market signals and government policies.

## STATE RENTAL HOUSING

The magnitude of the state rental sector (67 percent of the national housing stock) in the Russian Federation dwarfs the corresponding sectors in Eastern European countries: for example, in Hungary the state sector accounted for only 20 percent of the housing stock in 1989; Bulgaria, 9 percent; Poland, 34 percent (possibly plus 14 percent of units that were in rental cooperatives); and Czechoslovakia, 45 percent (Baross and Struyk, 1993: Table 1). The importance of state-owned housing—housing owned both by municipalities and by enterprises and government agencies (departmental housing)—means that any reorientation of the housing sector along market principles must begin with profound changes to this stock. Moreover, the fundamental problems of this sector, frequently recounted,<sup>23</sup> would demand it be given priority attention even if constituted a smaller share of units.

The Russian Federation has adopted a two-track strategy for effecting this change: a maximum effort at privatizing this stock and reform of the pricing and delivery of services in those units that remain in the public inventory. This section examines four aspects of this transition: privatization; the program of raising rents and introducing housing allowances; initial experiments in reforming the management of the existing stock; and, some special considerations involving department housing.

### **Privatization**

In one sense the privatization program is the *sine qua non* of housing reform in Russia: unless a significant volume of housing is in private hands, available for sales and rental in the market, there will be no market. Russian policy makers decided the gains from rapidly establishing a housing market (and giving a large number of families a direct stake in the overall economic reform program) outweighed the considerable costs which the policy of low-charge and no-charge privatization entailed. These costs include the adverse distribution of the nation's wealth, i.e., those who had obtained the best units through positions of influence in the old system (i.e., the *apparatus*) now realize the largest windfall gains. Additionally, cities are denied the possibility of collecting substantial revenues badly needed for capital projects or even to fund housing maintenance.

We begin this section by examining what has happened, particularly in 1992. We then discuss an emerging policy question: is there some amount of free privatization that is enough?

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<sup>23</sup> See, for example, Renaud (1991), World Bank (1992), Struyk, Kosareva et al. (1993).

## Developments

How has privatization fared? In examining the experience one must first realize that in practical terms the process did not really start until the beginning of 1992, when local governments had passed their laws necessary to implement the Federation law.<sup>24</sup> Second, in general, despite the generous terms, tenants in most cities were slow to seize the opportunity to buy. This can be explained largely by the combination of two factors. Tenants enjoy very strong rights: they are almost impossible to evict, even for nonpayment of rent; and they have the right to bequest the occupancy right of their unit to adult children or grandchildren registered as living in the unit. So the gains in tenure security from privatization are minimal. In addition, the poor condition of the buildings in which their units are located is a powerful deterrent—taking a unit is essentially receiving the right to pay for future rehabilitation. Moreover, uncertainties about the cost of the new property tax and future fees for maintenance cloud the decision.

Hence, the number of units privatized in the early months was modest. For example, the number of units privatized in February 1992 was 96,000. However, throughout 1992 there was a steady acceleration in the volume privatized: in April 130,000 units were privatized; in June, 146,000. Momentum continued to build and by December the monthly figure was 638,000. In the first two months of 1993, privatizations averaged 592,000, suggesting some leveling off—although this may also reflect the combination of capacity constraints in processing and the long holiday break in early January.

Tables 3.1 and 3.2 show the results for all of 1992. During the year a total of 2.6 million units were privatized, with another 1.3 million applications pending. Of the total, about 55 percent were municipal units. This represents 14.7 percent of the municipal stock. In contrast, only about 5.2 percent of the departmental housing in urban areas has been privatized. This much lower figure for departmental units reflects the widely held view that enterprises in particular are discouraging tenants from privatizing their units.

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<sup>24</sup> The possibility of renters privatizing their units had existed in various forms since the end of 1988, but few units were transferred. Official data indicate that before 1992 only about 204,000 units were privatized under all programs.

<b>Table 3.1</b> <b>Housing Privatization Summary</b> (thousands of units)						
	Total			1992		
	1993 <sup>a</sup>	1992	prior	municipal housing		departmental housing
				except Moscow	Moscow	
applications filed	1,525	3,993	281	1,997	477	1,519
privatized units	1,184	2,611	204	1,423	337	1,188
average square meters of space	47	49	49	48	47	52

**Note:** a. January and February only.

**Source:** Goskomstat, "Privatization of units in the State-Owned and Public-Owned Buildings, January - December 1992," (Moscow: author, processed, 1993).

<b>Table 3.2</b> <b>Privatized Units in 1992 as a Percent</b> <b>of the 1990 State Housing Stock</b>	
all units	10.2
municipal total	14.7
Moscow	16.3
other	14.3
departmental total	6.7
urban only	5.2

**Source:** Goskomstat, "Privatization of units in the State-Owned and Public-Owned Buildings, January - December 1992," (Moscow: author, processed, 1993), and authors' calculations.

Free-of-charge privatization was already the practice even before the passage of the amendments made it the law of the land. In 1992 for the country as a whole 82 percent of units were privatized without charge, except for a nominal processing fee; excluding Moscow, the share was 78 percent.<sup>25</sup>

<sup>25</sup> Why such a large share of units are sold without charge is illustrated in Kosareva and Struyk (1993) for Ekaterinburg and Novosibirsk, using the rules these two cities adopted for their programs.

The opportunity cost of low-cost and no-cost privatization to local governments appears to have been high. The data compiled by Goskomstat include the estimated value of the units sold. This is an artificial figure that is constructed by the local Bureau of Inventory Control (BTI) which maintains detailed physical records on all buildings. The value of a unit is computed on the basis of historical costs updated to 1990 using a construction cost index and then reduced for the extent of depreciation. Using data for Moscow, Lowry (1992) made a rough estimate that the BTI figure was about 3 percent of the market value in May 1992. If we apply this rule of thumb to the Rb40.9 billion figure reported by Goskomstat, then the value of units privatized is about Rb1.3 trillion. In 1993 prices the figure would be much greater. Against this, Rb2.4 billion was received in cash from tenants purchasing units.

What do we know about units being privatized and who is doing the privatizing? We can give a limited answer to this question based on information from a December 1992 survey of occupants of 2,000 units in Moscow that were state rentals at the beginning of 1992.<sup>26</sup> About 24 percent of these units had been privatized or tenants were awaiting certificates of transfer by the time of the survey. From the figures in Table 3.3 one sees that in Moscow half of the tenants had already privatized their unit or definitely planned to do so within the next six months.

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<sup>26</sup> This is a random survey of units in Moscow with access to a telephone, i.e., either a phone in the unit, or in the case of communal units a shared phone, which covers 92 percent of units *plus* an additional random sample of newly constructed units awaiting phone service that accounted for another 3 percent of units.

privatization status <sup>a</sup>	percentage
privatizers ("did")	23.4
interested ("will")	26.2
might	34.4
uninterested ("won't")	9.0
unclear	7.0

**Note:**

- a. **Privatizers (those who "did")**—those who have received a certificate of ownership through the privatization process, plus those who have applied to receive their unit, their application has been accepted and they are waiting for their certificate.

**Interested (those who "will")**—those who express a strong interest in privatizing their unit, i.e., they state explicitly that they intend to privatize within the next six months.

**Might**—those who have no plans to privatize.

**Uninterested (won't)**—those who have no plans to privatize their units and who responded negatively to at least two out of three questions about their intentions regarding privatization of their unit if certain developments occurred, such as rents being raised by ten times or a government announcement that free-of-charge privatization would end in a year.

**Unclear**—those who believe that in general flats in their building are not eligible because, for example, the building needs extensive rehabilitation, plus those in communal flats where the occupants of other rooms do not agree to privatization, and those who applied to privatize their unit but their applications were rejected for some reason.

Daniell et al. (1993b) analyzed the patterns of privatization in Moscow, with the maintained hypothesis being that the decision to privatize was determined by economic factors. They obtained an extremely good fit of a logistic model in which the dichotomous dependent variable took the value of 1 if the unit had been privatized and was zero otherwise and the independent variables was the market value of the unit. In another specification of the model, an independent variable was added which was highly significant: it took the value of 1 if the tenant said that both increased maintenance charges and higher maintenance fees were reasons for people not privatizing and was zero otherwise. Thus, the hypothesis of economic motivation was supported: higher unit values increase the odds of tenants privatizing and worries about cash flow reduce the odds.

Descriptively, households with members in high prestige jobs—directors, managers, and the intelligentsia—and pensioners have privatized their units at higher rates than other households. Pensioners appear to be motivated by capturing the asset value to pass to their heirs, in effect "cashing in" their occupancy right. Interestingly, pensioners showed the highest incidence of privatizing early in the program, but during the last three months of 1992, those with high prestige jobs became much more important. Other analysis of these data (Daniell et al. 1993a) reveal that those with high prestige occupations systematically live in better units. Again, those with better, higher value housing are those most likely to privatize.

### **Policy**

Housing privatization is clearly well underway; it is succeeding as hoped. With the enormous volume of units now being privatized each month, it is clear that a real housing market is being formed. In Moscow, for example, if we include cooperatives, about one-third of the housing stock is now in private hands. Secondary sales are plentiful and private rentals are beginning. Under these circumstances it may not be too early to ask if the terms of privatization should be changed in the future to preserve some of the stock as rentals and to generate some revenue for the cities from future sales. This could be done through legislation that permitted municipalities to announce that free privatization would be halted after six to twelve months. But should such a law be proposed now?

Three arguments can be advanced for giving municipalities this option. First, low income families may privatize their units and then not be able to pay the cost of maintaining them and the property tax. In this case they will be forced to sell their apartment and return to being renters. Only able to pay low rents, they will move to the worst housing and the least desirable neighborhoods. These low quality apartments will be vacated by families who can afford to purchase the flats offered by the low income owners.

The Law on Fundamentals moves to prevent this scenario from becoming a reality by making those who privatize their units eligible to receive a housing allowance, if they meet the income test. This certainly changes the terms of the debate,<sup>27</sup> but it does not eliminate the possible problem. In order to achieve equity and control costs, it is likely that the allowance payments for owners and renters will be determined using the same parameters. Now, assume a low income family finds itself in a building in which the condominium association votes to spend substantially more for maintenance than the amount provided by the municipality for rental units. In this case the family is supposed to pay the maintenance charge above that covered by its housing allowance subsidy. If it cannot do so, and

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<sup>27</sup> Analysts who have considered this issue have not foreseen the possibility of those privatizing receiving an allowance payment. See Buckley et al. (1992) and Hegedus et al. (1992).

assuming the other members of the association will not make the payment on the family's behalf, then it will be forced to move. Hence, raising the price of privatization may discourage some low income families from taking this step and prevent future problems.

In fact, we can address this point by examining the data for Moscow in which the profile of those privatizing their unit in the first nine months of 1992 is contrasted with those doing so later in the year. (The two groups are about the same size). They show that pensioners,<sup>28</sup> who accounted for 55 percent of privatizations in the first part of the year have declined in importance (to about 29 percent). This has raised the income profile of those privatizing their units. So, at least in the short term, the pattern is somewhat opposite to that implied above: many low income families, i.e., pensioners, were the first to privatize; and later families with at least somewhat higher incomes are becoming more dominant. This pattern suggests that inclusion of those privatizing in the housing allowance program was a wise decision, but the pensioners could still have difficulty paying for maintenance fees if they are substantially overhoused.

A second argument advanced for limiting privatization by raising purchase prices is to preserve a significant rental stock. Clearly, Russian cities are not yet in danger of eliminating their rental sectors. But should steps be taken to keep some share—25-30 percent—as rentals? Because of the lower costs involved in moving between rentals, many housing economists have argued that rentals serve an important function in promoting labor mobility and for newly formed households who begin with a "starter" unit and move more permanently to another unit later. We do not find this a very compelling argument. The supply of rentals can come from privatized units as well as from the existing stock. With the introduction of demand-side subsidies, it is not essential to promise a "social housing stock."

The third argument in favor of raising purchase prices to slow down sales is to pour badly needed funds into coffers of local governments. The argument against this proposition is that at higher prices the number of takers may be quite small. If those most interested in purchasing have already done so, as seems the case, then only a modest price increase could cut sales very sharply indeed.

Finally, while an across-the-board price increase may not be advisable, some thought must be given to whether those now being allocated apartments should have the same right to privatize as others. This has been the policy thus far, including families who have occupied newly constructed units. Broad equity considerations would suggest that the "right" answer is "yes." There is a rather compelling objection, however. The economic gains to a family now receiving a unit are so enormous that

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<sup>28</sup> These are elderly individuals or couples living alone, i.e., without their adult children present.

many families will be quite willing to make a side payment, perhaps a very large one, to obtain a unit and especially a good unit. In a few years, unit allocations should hopefully disappear as low income families simply receive a housing voucher to rent a state or private flat. But in the meantime, it may be wise to allocate new units without a right to privatize—at least until demand and supply are in better balance. Those on the waiting list could be offered a sizable subsidy for home purchase which would buy out their right to housing provided under *naym* social rental contract.

### ***Raising Rents and Implementing Housing Allowances***

While privatization is an important part of the story, it is far from the whole drama of reform of the state rental sector. As indicated above, a substantial number of families say they will not privatize or are not interested in privatizing their unit. Directly changing the basis on which the rental sector operates is, therefore, essential.

Fundamental in this process is the dual policy of raising rents and introducing housing allowances (means-tested payments to low income families to assist them in paying rents). With higher rents, there will be enough income to fund good, competitive maintenance of the housing stock. Additionally, as rents rise to market levels, there will be no particular attraction to families to wait to be allocated a state unit: similar units, whether private or state, will cost the same; why wait? Those households who do qualify for a housing allowance can find a unit they can afford with the allowance payment in the open market; they will be able to rent it. Consequently, over time as the supply of private rentals grows the seemingly infinite waiting lists will simply quietly disappear, and along with them a major source of inequitable treatment and possible corruption.

Note that "rents" consist of two components that are charged and paid separately. Maintenance fees have remained unchanged since 1928 and cost 16.5 kopeks per square meter of living space.<sup>29</sup> Charges for communal services are computed separately for about a dozen different services. Of these, only electricity and telephone usage are monitored for individual units. Charges for communal services have been raised fairly frequently in the last few years, with charges for some of the less important items now covering full cost.

Tenant payments, however, now make a quite insignificant contribution to the costs of providing services. In Moscow, the estimate is that they covered less than 1 percent of maintenance costs at the end of 1992. This contrasts with 35 percent in 1990. Even in March, 1992, the average tenant devoted about 2 percent of its income to rents (maintenance fees and communal services); for the poorest 25

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<sup>29</sup> Actually, beginning in April 1991 it was possible for local Soviets to increase maintenance fees, and a few, such as the one in St. Petersburg, did.

percent of the population, these expenditures accounted for only 4.2 percent of income.<sup>30</sup>

Cities have adjusted in two ways to the sharp reduction in total costs covered by tenants: cutting services and increasing subsidy payments from their budgets. Earlier it was noted that funded maintenance budgets were sufficient to cover only 25-30 percent of estimated requirements in 1992. In Moscow, the City still devoted 14.2 percent of its total budget to existing municipal housing: 3.4 percent for current maintenance; 8.3 percent for capital repairs, and 2.5 percent for communal services subsidies (Olson, 1993). If maintenance services had been adequately funded, they alone would have accounted for 10.2 to 13.6 percent of the City's budget. As it is, deferred maintenance is piling up, which will require additional capital repairs in the future.

These figures highlight two realities. First, the cost of providing services is an enormous drain on cities' current resources and will be an even larger drain in the future. Cities are anxious to recoup their costs. And second, the great majority of families can afford to spend a substantially greater share of their incomes for housing.

The Law on Fundamentals requires that rents be raised to fully cover operating costs within a five year period, and local governments are required to introduce housing allowances for social housing. The Government's Program HOUSING makes clear that raising rents to market levels is the eventual goal; Moscow's plan has the same objective. The Russian Federation is to issue guidelines to local governments on the design of the program of raising rents and introducing allowances in the near future. The Program HOUSING and other documents make clear, however, that full "shock therapy" is not to be the order of the day. Rather, rent increases will be on a step-by-step basis.

The housing allowance provisions of the Law on Fundamentals are based on a scheme in which allowance payments are made using a "gap formula:"

$$S = MSR - tY,$$

where S is the subsidy payment to the tenant; MSR is the "maximum social rent," i.e., the rent payment per square meter of total space times the number of square meters defined as the social norm for a family of a given size and composition; t is the share of income deemed reasonable for the family to spend on housing; and, Y is household income. Thus, the allowance covers the gap between the cost of an

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<sup>30</sup> The figure on the share of income spent on housing is from Struyk, Kosareva et al. (1993), and the figure on the share of total costs covered by tenant payments was provided by the Moscow Department of Communal Services.

adequate accommodation and what the family can reasonably afford to pay.<sup>31</sup> The household pays the full cost of housing above the social norm. Families with incomes greater than MSR/t are not eligible for the program, as they would not receive a positive payment.

The Law on Fundamentals (Article 15) foresees that overhoused families will be under increasing pressure to move to smaller units as rent payments are increased. The drafters of the law were deeply concerned about overhoused tenants being "trapped" in units they could not afford. The law, therefore, provides that local governments must provide "overhoused" families who request smaller units with units that meet the social norm. While the new unit is being found, the family pays only for the social norm of housing, thus putting the city under pressure to find a suitable unit. Given the high volume of apartment swaps—for example, about 95,000 or 3 percent of the stock per year in Moscow—and the large number of families seeking larger units, effecting these transfers should not be problematic.

Moscow has prepared the most detailed plan for raising rents and introducing allowances to date, and will probably implement its program some months ahead of other cities.<sup>32</sup> The first increase in maintenance fees was scheduled for April 1 and would have raised rents from 16.5 kopeks per square meter of living space to Rb1 per square meter of total space—an increase of about ten times, after adjusting for the shift from using total instead of living space in the calculation.<sup>33</sup> The increase has,

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<sup>31</sup> A detailed explanation of this formula and simulation results for Moscow for a program using it are in Struyk, Kosareva et al. (1993). This same type of formula has been adopted in Estonia and Hungary, is being used in the experiment being prepared in Bulgaria, and has been proposed for use in Czechoslovakia.

<sup>32</sup> In fact, in March the Government decided that Moscow and Nizhni Novgorod would be permitted to implement rent increase programs on an experimental basis while other cities were still developing their proposals. The proposal developed by Nizhni is a "payment compensation scheme." It involves a new tax on enterprises and contributions per worker and per pensioner by government into a new maintenance housing fund. The fund will make payments into family housing accounts on a per person basis or all citizens, and these payments will be used to help make rental payments. All persons receive the same payment regardless of incomes. For a discussion of such a program relative to housing allowances, see Struyk et al. (1993a).

<sup>33</sup> As noted, an unknown of other cities have already raised fees for maintenance by amounts this large. For example, St. Petersburg implemented a ten times increase in September 1992. None, however, have accompanied the increases with the introduction of a housing allowance program. Maintenance fees were raised under a law on the budget passed in April 1992 which gave local soviets the power to increase rents.

however, been delayed while the City obtains the final approval of its program.<sup>34</sup> The Government of Moscow has adopted the following schedule of price increases through July 1994:

<b>Table 3.4</b>		
<b>Schedule of Increases in Maintenance and Communal Services Charges</b>		
<b>date</b>	<b>increases<sup>a</sup> in</b>	
	<b>maintenance fees</b>	<b>communal services charges</b>
April 1993	10 times	—
October 1993	30 times	2.6 times
January 1994	50 times	15 times
July 1994	—	48 times

**Note:** a. compared with charges in effect in October 1992

**Source:** Moscow Government Decree no. 3, "On the Elaboration of the concept of Changes in the Rent Payment and on Housing Allowances in the City of Moscow," January 5, 1993

Housing allowances become effective on October 1, 1993. Beginning July 1994, the Government of Moscow will determine the size of the increases in payments scheduled for each six month period. The increased charges for maintenance and communal services will apply to departmental as well as municipal housing. Because of the extreme rate of inflation, the share of total costs that will be covered by tenant payments is not clear. The target is 20 percent.

The Government of Moscow plans for the following groups of households to be eligible to receive payments, providing they having qualifying incomes: renters in municipal and departmental units, and owners of privatized units in the same stock; owners of cooperative apartments; and, owners of condominiums who obtained their unit through privatization. The Government is also considering making renters of privately owned units eligible. Not eligible are owners of individual units and those who purchase units in the open market (versus obtaining a unit through the privatization program), including those who buy a unit that was privatized. While the details of treatment differ among these various groups, the general principle is that

<sup>34</sup> The cabinet of the Russian Federation in its meeting of March 18, 1993 decided in principal to permit Moscow to proceed with its program. The City has now submitted a letter to Prime Minister for his formal authorization. However, during the run-up to the national referendum of April 25, various price increases are being deferred; and it seems likely that Moscow's rent increase will be delayed until early May.

the parameters of the payment formula defined for renters in municipal housing will determine subsidy payments in other tenure situations as well.<sup>35</sup>

What are the expected impacts of implementing the rent increase-housing allowance package? In fact, a large volume of simulation analysis has been undertaken to respond to this question. A recent "guidebook" for republican and municipal governments outlines six different programs that could be implemented over the five year period mandated in the Law on Fundamentals (Daniell, Puzanov, Struyk, 1993). The six strategies vary two parameters: (1) the speed at which rents are raised to cover operating costs fully, and (2) the magnitude of the net (after allowance payments) increase in revenues to the city from increasing rents. Three options for the speed of increasing cost coverage are combined with two variants for the relative size of the city's net revenues to form the six strategies.

Implementation of these programs was simulated for three cities: Moscow, Novosibirsk, and Ufa. As shown in Table 3.5 the conditions in the three cities differ markedly.

Indicator	lowest value		highest value	
household income (Rb/mo.)	Novosibirsk	Rb6,112	Ufa	Rb10,530
individual units	Moscow	0%	Novosibirsk	9%
self contained units	Ufa	74%	Novosibirsk	86%
"overhoused" families <sup>b</sup>	Ufa	18%	Novosibirsk	36%
av. unit size (sq.m.)	Ufa	40	Moscow	46
full operating cost <sup>a</sup> (Rb/sq.m./mo.)	Moscow	49	Novosibirsk	115
tenant payment (Rb/sq.m./mo.)	Novosibirsk	1.1	Ufa	2.5

**Notes:**

- a. income and maintenance cost figures are for October 1992; other figures are for March 1992 (Moscow) or the fourth quarter of 1992 (Novosibirsk and Ufa).
- b. The definition of "overhousing" is approximately the "social norm" adopted for Moscow's program.

Among the factors with substantial effects on the results of raising rents and implementing the "gap type" housing allowance program is the percent of families overhoused (since overhoused families experience larger increases in rents); the

<sup>35</sup> The administrative details of the Moscow program are given in Khadduri and Struyk (1993).

absolute costs of providing services particularly in relation to current tenant payments (since high cost places will have to increase rents more); and, the level and distribution of household incomes, which obviously affects ability to pay.

Key findings of the simulation analyses include:

- The program of raising rents and implementing allowances is self financing during the transition because increased rent collections are larger than the allowance payments—often by a substantial amount.<sup>36</sup> This assumes that the same program is implemented for departmental and municipal housing and that the city receives the rent payments and makes the allowance payments.<sup>37</sup>
- The program does an excellent job of protecting the poor, while at the same time encouraging overhoused families to move to smaller units, because the participant pays the full cost of space above the program standard.
- There are important differences in outcomes across the three cities of implementing exactly the same program. These differences argue against any single national program with rigid program parameters. Even the guidelines such as those contained in the Program HOUSING, which indicate one-half of all expenses should be covered in the first year are very likely a mistake as they could cause cities like Novosibirsk to have overhoused households spending a large share of their incomes on housing with little time to adjust; moreover, in Novosibirsk 100 percent of families would be eligible for payments—an enormous administrative burden at the start of a program.

### ***Improving Maintenance***

An even casual observer is struck by the poor condition of the housing stock in Russia. The December 1992 survey of 2,002 Moscow units that were state rentals at the start of the year discussed earlier also provides the most detailed, systematic information to date on the conditions under which Muscovites live (Daniell et al., 1993a). The survey generated data on two types of outcome: (a) building conditions and interruptions in services (e.g., heat), and (b) the experience of tenants when they requested help from the responsible state maintenance company (RAiU), which provides services to about 7,000 units. Obviously, the outcomes are the product of both the treatment by tenants of public spaces and their apartments and the quality

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<sup>36</sup> When the market rents are reached and if profit margins are low, then the cost of services will approximately equal rental payments and the housing allowances will largely be "on budget."

<sup>37</sup> This finding may not hold in cities where a large share of the stock is composed of individual units and the owners of these units are made eligible to receive allowance payments.

of maintenance provided by the RAiUs, i.e., all problems cannot be attributed unequivocally to the RAiUs. Still, the general patterns suggest extraordinarily poor quality of services provided by the RAiUs:

- Both interviewers' observations and tenants' opinions agreed that the entryways in 14 percent of the buildings were in such bad condition as to require full rehabilitation; about another one-third need some rehabilitation. Combined, nearly one-half of the entryways in state rental housing are so beaten up as to need at least partial rehabilitation.
- For the previous two months, lights were reported not working in the public spaces most of the time in most of the buildings: fully 40 percent of respondents reported lights were off for the whole month. The situation is even worse for security systems (numeric code systems or a concierge to watch the door): three-fourths of all systems were simply not working.
- 30 percent of respondents report rubbish in the halls or stairways frequently, and about the same share report frequent breakdowns in lift services—either the whole month or, during the past two months, 3 or more breakdowns or for more than 1-2 weeks at a time.
- 10 percent of tenants reported that their heat was off frequently in the preceding two months—3 percent were without heat for a whole month. Similarly, 9 percent reported that their toilets leaked most of the time.
- Fully a quarter of all respondents who reported having a problem that should have been corrected by the RAiU said they had not even bothered to report it.
- Looking at all the cases in which tenants ask for assistance from the RAiU, the repair was eventually made in 55 percent of the cases (35 percent of the time the repair was made more or less on the schedule promised by the RAiU). In 39 percent of these cases the repair was simply never made.

Thus far the offices responsible for improving services have not shown much initiative. To our knowledge the Committee on Municipal Services of the Russian Federation has advanced no concrete proposals. Indeed, it has expended considerable energy trying to prevent the RAiUs from losing their monopoly positions.<sup>38</sup>

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<sup>38</sup> For example, the committee in drafting the amendments to the privatization law inserted language making impossible for condominium associations to use a management company other than the RAiU for the building proper, although they permitted owners to engage private firms for their individual units.

The only concrete development to date has been two pilot projects, one in Moscow and one in Novosibirsk, to introduce competitively selected management firms into municipal housing. Both pilot projects are being carried out with assistance from USAID. The launching of the Moscow is described in Box 3.1. Officials in both cities have been highly supportive of the pilots and the pilots have generated interest in other cities, but no imitators yet.

Even if these pilot projects develop rapidly in their two cities,<sup>39</sup> it is obvious that the goal of a general improvement in housing maintenance is on the far horizon. Perhaps the best hope is for the condominium associations to select quality maintenance firms for their buildings.<sup>40</sup> The general experience in Eastern Europe is that such firms readily emerge when there is a demand for their services. In Moscow, for example, there were 23 expressions of interest in the RFP for the management of three "packages" of buildings in the pilot project. In Prague District II, the first district in that city to contract with private management companies, there were 25 expressions of interest in response to its initial announcement.<sup>41</sup> With maintenance fees for public management of the buildings increasing, private firms should be able to offer their services at profitable fee levels.

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**Box 3.1**  
**Moscow Housing Management Pilot Project**

On March 1, 1993, the Western Prefecture signed three Pilot Program contracts with private Managers. The Pilot was implemented after 8-months of planning and training. The Pilot will explore private and competitive alternatives to traditional public management and maintenance. The premise of the Pilot is that private management will be less expensive, and will lead to a better quality of life for the tenants. The contracts are written for a one-year, renewable term. The contracts represent a Moscow City Government total funding commitment of 42.2 million rubles over the contract period (to be indexed for actual inflation). On a per unit month basis, this is about 50 percent more than fees now being received by the public companies, which are estimated to be about one-third of the amount needed.

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<sup>39</sup> The goal of the technical assistance team in Moscow is to have 500,000 units under competitive management by the end of 1994.

<sup>40</sup> The regulation on condominiums issued by the Government of Moscow does not specify the minimum share of units that must be in private ownership in a building before a condominium association can be created. It does say that when 60 percent of the units in a building have been privatized, such an association must be created. Note that in mixed ownership buildings, i.e., those in which the municipality still owns units, the municipality votes the shares it controls in making the association decisions. Therefore, if those representing the municipality wish to prolong the period of maintenance by the state company, they could be quite effective for an extended period, especially if there is some division of opinion among the new owners.

<sup>41</sup> Kingsley, Tajcman, and Wines (1993).

Until now, all Municipal management and maintenance has been provided by about 500 public entities, known as RAIU's. Organizationally, each Prefecture is divided into Sub-Prefectures (equivalent to large neighborhoods), and there are numerous RAIU's within the Sub-Prefectures.

The Pilot introduces several new concepts in Russia:

- The first time that private management will be used in Municipally-Owned Housing.
- The first time that a "Request For Proposals" (RFP) process was used to solicit services in the municipal housing sector. New concepts introduced include: advertising for proposals, freedom of information, open meetings, equal opportunity employment, deadline for proposal submission, objective rating criteria, "Notice To Proceed," and termination for nonperformance.
- The first time that Contracts for real estate management used performance factors such as "clean and attractive," "removal of hazardous conditions," and "preventive maintenance." These concepts had to be operationally defined.

**Structure of the Pilot.** 2,000 units were selected for inclusion in the Pilot: 600 in the Kutusovsky Sub-Prefecture, and 1,400 in the Fili-Davidkova Sub-Prefecture. The Kutusovsky units are in Central Moscow, and the Fili units are in suburban Moscow. The units also vary in terms of age, construction type, and building type (high-rise versus mid-rise). This diversity provides for a sample that is representative of all building types in Moscow, and insures that the Pilot is easily replicable on a city-wide basis.

The "Board of the Unified Customer" (or DEZ) acts as the Owner for the purpose of the Pilot. There is one DEZ for each Sub-Prefecture, and the Chiefs of the DEZ signed the contracts for the Municipal Owner. Personnel from the DEZ's and the Prefectures were trained in real estate management and maintenance techniques. The training consisted of 16 classroom sessions conducted from October-December 1992. In addition to the classroom training, three representatives of the Owner attended a one-week "Owners Study Tour" to experience how management works in the United States.

The Pilot is specific to management and maintenance tasks; it excludes nonmanagement tasks with which the RAIUs were encumbered, such as passport control, communal services charges calculations (these include heat, gas, and water), and draft registration. This specificity will allow the private Managers to concentrate on the management areas of greatest need: security; routine and emergency maintenance response times; rubbish and snow removal; cleanliness of the common areas; removal of hazardous conditions; preventive maintenance; and landscaping.

The procurement of the Contractors was patterned after a U.S. style "Request For Proposals" (RFP). To solicit bids, advertisements were placed in Moscow newspapers of wide circulation. Twenty-three expressions of interest were received, and eleven formal proposals.

**Monitoring.** Evaluation is a key component of the Pilot Program. The Pilot is "results" rather than "process" oriented; i.e., the Owner is not concerned with *how* the common areas were cleaned, but *whether* the common areas are clean.

Performance is measured against the Contractor's approved Work Plan and Budget. Monthly budget reports (cumulative, year-to-date) must be submitted to the Owner. In addition to holding regular meetings with the Contractor, the Owner will make regular inspections to assess and verify site conditions.

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Tenant satisfaction will be a critical measure of the Pilot's success. Surveys of 300 units included in the Pilot Program will be conducted to measure baseline, short-term, and long-term results. Baseline surveys were taken in February 1993 to assess satisfaction with RaiU management. Follow-up surveys will be taken in May and December to assess satisfaction with the Contractors.

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### ***Departmental Housing***

Departmental housing accounted for 44 percent of all urban housing in 1990 and 56 percent of state housing in urban areas (table 0.2). As enterprises are under increasingly competitive pressure they may wish to stop providing housing and other costly ancillary services to their workers and concentrate more on business. Consequently, they would want to shift as much of these responsibilities to municipal and other authorities. This section looks at developments in departmental housing, concentrating on issues of ownership and rents and maintenance.

#### **Ownership**

Have enterprises been rapidly divesting themselves of their housing inventories as hypothesized above? The answer appears that, thus far, they have been reluctant to part with these assets, presumably because they believe that having housing is key to attracting workers or that carrying housing on their balance sheets enhances their prestige. There are three types of information supporting this conclusion.

First, we saw earlier that privatization of departmental housing proceeds more slowly than for municipal housing. Numerous housing professionals have asserted informally to us that enterprises actively discourage their workers from privatizing their units. The only systematic information we have on this point is from the survey of the occupants of 2,000 Moscow state apartments cited earlier. Because of the limited volume of enterprise (versus ministry) housing in the City, information for Moscow is not the best for this purpose. Nevertheless, these data show that as a percentage of units that remain departmental housing, 31 percent of households of these units reported that their application for privatization had been rejected or they had been told that the firm or ministry "did not agree" that the unit could be privatized. The parallel figure for municipal housing is .5 percent.

Second, enterprises have continued to construct a substantial volume of new housing from their own resources. Recall that in Section 2, we reported that in the past few years enterprises have emerged as the dominant customer for new construction. While the absolute volume of housing commissioned by enterprises has declined roughly in line with total production, they clearly have not radically reduced their investments in housing.

Third, the number of units transferred from departmental to municipal ownership is not very large. National data are not available on this point.<sup>42</sup> Again, though, we have information for Moscow. In 1991 the city accepted departmental housing containing 1.6 million square meters of space in flats, or about 5.5 percent of the total departmental stock as of 1990. In 1992, however, it accepted less than 100,000 square meters because of its lack of funds for subsidizing maintenance.<sup>43</sup> The information for Moscow indicates the difficulty of interpreting figures on transfers as an indicator of enterprises behavior: transfers are only completed when enterprises offer the housing *and* cities accept them.

### **Maintenance of the Departmental Stock<sup>44</sup>**

With departmental housing such a large share of the total housing stock, the quality of maintenance provided to these units has a profound affect on the housing satisfaction and on the rate at which the existing stock will have to be renovated or replaced. Since rehabilitation and new construction are so expensive, strong incentives for maintenance of this stock should be an important topic of public policy.

The general view is that departmental housing was better maintained than municipal housing under the central planning regime. On the other hand, due to the radical change in incentives faced by self-financing enterprises (businesses) since 1990, when the profits tax was introduced, experts believe there has been a sharp reduction in maintenance and housing quality. Because non-self-financing entities (on-budget organizations), such as government ministries, have not been subjected to the change in incentives, the direction and extent of change for them is much less clear. However, the general cuts in budgets would suggest reduced maintenance for this stock as well.

Under the old regime, each enterprise operated under strong norms specified by Gosplan and administered by the relevant branch ministry. All budget line items were specified by the ministry, subject to negotiation with the enterprise. Housing maintenance and communal services appeared as a line item in the budgets. Generally speaking, the norm for maintenance was very low. However, the enterprises were successful in shifting a substantial amount of the maintenance

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<sup>42</sup> The Committee on Municipal Economy reports that it assembled these figures for 1991 but that the one copy of the document has been lost. Data for 1992 are expected in May.

<sup>43</sup> Information from the Department of Communal Services, City of Moscow.

<sup>44</sup> Information in this section is based on interviews with Irina Minc and Igor Bychkovsky of the Institute for Housing and Municipal Economy and Ludmila Kuznetsova and Yelena Medvedeva of the Moscow Department of Communal Services, and on analysis of the law on the profits tax.

expenditures into accounts for the enterprise's main activity, e.g., plumbers and carpenters were carried on the books as working for the main production unit when they were really maintaining housing. Non-self-financing entities (on-budget organizations), particularly Russian Federation government agencies, continue under this system, but they likely have difficulty hiding maintenance workers.

The new system was introduced as part of the liberation of enterprises from the control of the branch ministries, including giving them a clear profit incentive. The incentives to enterprises for making expenditures on housing maintenance are now fairly complex. The following factors are at work:

- (1) The enterprise can deduct from its taxable profit expenditures for housing maintenance (net of tenant contributions). The tax rate is 32 percent. However, there is a limit on these deductions that is set by local governments. In Moscow, for example, the maximum deduction was set at Rb150 per square meter of living space per year for the tax year of 1992. This cap applies to both routine maintenance and capital repairs. For comparison, in Moscow 1992 expenditures for routine maintenance of municipal housing were only about Rb154 per square meter of living space.<sup>45</sup>

Obviously, expenditures above the deduction limit cost the enterprise more, and are thereby discouraged. However, the limit is locally determined. Governments in industrial centers may set the limit at a high level even though the result is a loss of local government tax revenue.<sup>46</sup>

- (2) Management of the enterprise enters into a "collective agreement" with the workers on the distribution of after-tax profits. These profits go into two funds: the Fund for Consumption and the Fund for Investment. Because the majority of workers often do not live in the enterprise's housing, they prefer a smaller expenditure on maintenance and a larger contribution to the Fund for Consumption, which makes payments to workers for vacations, etc. (Obviously, this procedure will become more complicated when the firm is privatized, because the agreement will also have to take distributions to share holders into account.)

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<sup>45</sup> This figure was determined by the City's Department of Finance. We do not know the basis for the calculations.

<sup>46</sup> For a description of the allocation of tax bases see Wallich et al. (1992). While these allocations have been made in principle there is still a good deal of bargaining between the federation and lower levels of government over the distribution of taxes collected.

- (3) Some enterprises are not making profits, and for them there is no possibility to deduct maintenance expenditures from taxable income; and they have an even lower incentive to maintain their housing.

Overall, it would appear that most enterprises have weak incentives to spend money on maintenance, since even profitable enterprises must pay for the majority of expenditures. The workers who control the allocation of after-tax profits are also likely to want have more profits to distribute rather than sheltering some profits through maintenance expenditures.

Fragmentary information on current maintenance gives a mixed picture on the quality of maintenance. The city of Nizhni Novgorod assembled data for the last quarter of 1992 on the monthly maintenance costs of enterprises with large housing holdings (over 100,000 square meters). Striking about these figures is the range of expenditures on maintenance, as shown in the figures below for selected firms.<sup>47</sup>

<u>enterprise</u>	<u>rubles/sq.m. living space</u>
GAZ	86
Sokol	57
Ulyanov	34
Stalj	29
Gydromash	32

By comparison the same figure for the municipally owned housing was Rb24 per square meter. In Nizhni, at least, enterprises owning large housing stocks are spending more than the municipality.

We can use data from the Moscow survey on the condition and location of municipal and departmental housing to develop a suggestive picture of comparative upkeep.<sup>48</sup> These data show conclusively that in Moscow the conditions in the municipal stock are better: municipal housing scored better on 17 of 19 indicators studied and on 11 of the 12 for which the differences were statistically significant. From the information cited earlier, it is clear that the conditions in general are not good; so the quality of residential living in the departmental stock must be quite bad. Unfortunately, we do not have a data set with full information on both housing conditions and expenditures for departmental and municipal units for any city, i.e.,

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<sup>47</sup> Data from, City of Nizhni Novgorod, "Conceptual Proposals on the Reorganization of the System of Upkeep and Maintenance of Housing in the City of Nizhni Novgorod," (Nizhni Novgorod: author, 1993), Table 1.

<sup>48</sup> Information from Daniell et al. (1993a).

it may be that departmental expenditures in Moscow are low and thus the poorer quality would be expected.

### **Housing of Privatized Enterprises**

With state industrial firms now being privatized in significant numbers, the treatment of housing stock belonging to privatized firms has become a more acute issue. Matters were clarified substantially in a Presidential Decree issued in January 1993.<sup>49</sup> There are two key provisions for housing. First, when an enterprise is privatized, the housing stock cannot be included in the privatized property. Second, regarding use and maintenance of the housing, the enterprise and local authorities are to negotiate and sign an agreement on use and financing. If an agreement cannot be reached voluntarily, then an arbitration procedure is to be invoked, with a representative of the Federation participating. We do not have information on how this process is working.<sup>50</sup>

### **Housing Allowances in the Department Stock**

Residents of departmental housing will be eligible to receive housing allowances. It is not clear, however, how this will work in practice; and it appears that this issue will be resolved by republican governments in designing their programs for increasing rents and introducing allowances.

Two issues are prominent. One is whether owners of departmental units (hereafter called "agencies") will be required to follow the same schedule of increases in maintenance fees and charges for communal services and use the same parameters as the municipality in computing their subsidy payments. Agencies could argue that they are spending more than municipalities and therefore need a higher MSR, which would result for higher subsidy payments for their occupants compared with occupants of municipal housing with the same income. The City of Moscow has decided to require agencies to use the same parameters as the city's program.

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<sup>49</sup> Presidential Decree no. 8, January 10, 1993, "On Use of Socio-Cultural and Communal-and-Everyday Service Facilities of Privatized Enterprises." Article 9 of the Law on Fundamentals of Housing Policy of the Russian Federation also addresses changes in ownership; it states that the upon privatization, the ownership of the housing stock will be transferred to the enterprise's designee, if there is one.

<sup>50</sup> The Supreme Soviet has also recently passed a law making it possible for non-state enterprises to lease out dwellings belonging to them. Municipal housing is explicitly excluded, although republican-level governments (including Moscow and St. Petersburg) were given the right to permit municipalities to lease out housing in the Law on Fundamentals of Housing Policy in the Russian Federation (Article 17). The statement on enterprises was in *Commerzant*, March 11, 1993, p. 26.

The other issue is who pays for the allowance payments. In the earlier discussion of housing allowances it was noted that increases in rental revenues would nearly always exceed the housing allowance payments during the transition, i.e., until rents rose to full operating costs. Hence, the typical enterprise will not lose money during the transition. But one can imagine agencies with low-income and underhoused (relative to the social norm upon which subsidy calculations are based) work forces; these agencies will lose money even during the transition. Also, at the end of transition, all allowance payments could be the responsibility of the agencies. To date how to handle this "steady state" problem has not been confronted, but it clearly needs to be in the next year or so.

### **Conclusion**

Not surprisingly, the issues involved with departmental housing in the transition of the housing sector are complex. Perhaps most striking is the apparent desire of enterprises to retain their housing. The issues created in the transition are being addressed pragmatically as other reform actions require. Most prominent are the disposition of the housing belonging to firms being privatized and treatment of income eligible tenants in the housing allowance program. Nevertheless, more systematic attention should be given to improving the maintenance of this stock during the transition and to facilitating enterprises divesting themselves of their housing assets. The City of Moscow has made the sensible proposal to the Federation that the City would accept departmental housing in exchange for either direct budget support or a more favorable sharing rate for the corporate profit tax during the transition.

## HOUSING FINANCE

Expanding long-term housing lending in Russia is a challenging task. The situation can be characterized simply. While there has been limited housing lending, mortgage lending, in which the housing asset serves formally as collateral did not exist (before the passage of the Law on Collateral in 1992). The banking system is embryonic and the creation of over 1,500 new commercial banks in the past two years has resulted in a poorly supervised and probably fragile system.<sup>51</sup> High and volatile inflation rates imply potentially great interest rate risk for long-term lending, since the banking system's liabilities are heavily concentrated in short-term accounts. And, there is possibly grave credit risk associated with housing lending because the current confusion about the enforceability of foreclosure in case of default, despite existing legal provisions.

### *Traditional Housing Lending*

Traditional long-term housing lending in the Soviet Union was quite simple and can be characterized by the following four points:

- (1) Loan volume each year was determined in the centrally-developed economic plan. Beginning in 1988 all long-term housing lending was done by the State Savings Bank, also known as Sberbank, which was changed into a joint stock bank in 1991.<sup>52</sup>
- (2) Lending was for individual construction and housing cooperatives.<sup>53</sup> Since individual construction was forbidden since 1961 in cities of over 100,000 population, only cooperative loans occurred in these places; and individual loans were concentrated in smaller cities and rural areas.<sup>54</sup>
- (3) Housing loans were not explicitly secured by the property as collateral and the possibility of eviction in the case of default was questionable. In practice, lenders protected themselves by typically having loan payments deducted from wages by employers; where this was not possible, guarantors were sought and

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<sup>51</sup> International Monetary Fund et al. (1991), vol. 2, Chapter IV.5.

<sup>52</sup> Before this loans to individuals were made by Gosbank and Stroibank. Loans to members of cooperatives were made by Zhilsots Bank and Stroibank.

<sup>53</sup> There are two types of cooperatives: housing building cooperative (HBC) and housing cooperatives (HC). For HBCs the borrower is the cooperative who on-lends to individual households. For HCs individual members obtain loans to purchase the units from a seller—municipal government or an enterprise. See Andrusz (1991) for a thorough discussion of housing cooperatives in the USSR.

<sup>54</sup> In reality, housing cooperative were highly concentrated in Moscow and St. Petersburg.

the bank could have wages garnished for nonpayment. Sberbank experienced low levels of delinquencies.<sup>55</sup>

- (4) The loan instrument is a fixed rate loan interest rates were low and loan periods long.

Basic information on the lending of the past few years is given in Tables 4.1 and 4.2. We focus here on events through 1991; developments in 1992 are discussed in the next section. The data in Table 4.1 show that loans to individuals can be characterized as having extraordinarily long terms and carrying very low interest rates. These loans carried subsidies: the 2 percent interest rate charged until 1991 was less than the bank's cost of one-year time deposits and only 1 percentage point above the official inflation rate. In 1991, the loan rate was 2 percentage points below the one-year time deposit rate. Maximum loan amounts were reasonable compared with the cost of housing.

Lending for units constructed for Housing Building Cooperatives (HBC) carried deeper interest rate subsidies—the interest rate on these loans being only .5 percent. The loan term was shorter than on individual loans, but at 25 years still long enough to permit low monthly payments.

Even in 1990, loan interest rates were negative in real terms. By 1991 they were sharply negative, setting the stage for even worse conditions in 1992. As shown in Table 4.2, the good news for Sberbank is that its volume of long term lending for housing has been small, and in recent years has fallen in real terms. There are several ways to make the point about the small loan volume. In 1991, the number of loans to individuals was the equivalent to about 0.2 percent of the 1990 housing stock, and 0.8 percent of the 1990 single family housing stock.<sup>56</sup> Similarly, such lending constituted only 0.2 to 0.4 percent of gross domestic product.

There is no question that housing lending in the Russian Federation has been low compared with other countries. The figures in Table 4.3 document that among middle-income countries the Russian Federation had an extremely low ratio of mortgage loans to total housing investment. This, of course, is largely attributable to the enormous role played by direct state investment in the production of new rental housing. But even compared with Poland and Hungary the Russian figure is tiny.

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<sup>55</sup> As of the end of 1991, Sberbank's cumulative delinquent payments were Rb6.4 million on a housing loan volume of Rb10 billion. Source: interview with Sberbank officials, M.A. Gavrilin and A.K. Abramova, August 12, 1992.

<sup>56</sup> Data on the 1990 stock are from the State Committee on Statistics of the RSFSR (1991).

Table 4.1 Housing Loan Terms in the Russian Federation 1988-1992						
	1988	1989	1990	1991	1992	1993 (April)
Loans to individuals <sup>c</sup>						
interest rate	2	2	2	3	8(+12) <sup>a</sup>	g
loan term (years)	50	50	50	25	20	
maximum LTV	75	75	75	75	75	
maximum loan (th.rub.)	20	20	20	20	—	
Loans to cooperatives (HBC) <sup>d</sup>						
interest rate	.5	.5	.5	3	8(+12) <sup>a</sup>	g
loan term (years)	25	25	25	25	20	
maximum LTV <sup>b</sup>	70	70	70	70	70	
GDP deflator, 1988=100 <sup>i</sup>	100	103	114	246	4084	h
Interest on 1-year time deposit (%)	3	3	3	5	30 <sup>c</sup>	100 <sup>f</sup>

**Notes:**

- a. Beginning in April 1992 individuals or cooperatives paid 8% and 12% was subsidized by the state budget. For the period January 10 to April 1, 1992 the interest rate on loans to individuals was 15%.
- b. LTV was determined through special decrees of the Soviet government. Some regions, e.g., Siberian coal areas, had and still have LTVs of 80%.
- c. Since August 1, 1992. For the period January 1 to August 1, 1992, the interest rate was 10%.
- d. House Building Cooperative.
- e. Loans for construction of individual houses.
- f. Since April 1, 1993; from January 1, 1993, the rate was 60%. Beginning in January the interest paid on deposits was being compounded; previously not compounding had occurred.
- g. In early April 1993, future loan terms were being determined by the bank.
- h. Data not available. Monthly increases in consumer prices for January-March are widely quoted as 25%.
- i. Source: Ministry of Economy, Center for Economic Forecasting.

**Source:** Sberbank.

	1988	1989	1990	1991	1992 (9 mo)
Loans to individuals number (thousands)	73.4	53.1	124.4	94.8	c
volume <sup>a</sup>	661	438	1,296	2,127	10,138
average loan size <sup>b</sup>	8.9	8.2	10.4	22.4	c
Loans to cooperatives volume <sup>a</sup>	574	502	468	648	1,293
Total volume <sup>a</sup> current prices	1,235	940	1,763	2,775	11,431
1988 prices	1,235	912	1,682	1,191	382
ratio: loan volume to GDP as percent	.32	.16	.28	.23	.14

**Notes:**

- a. millions of rubles, current prices
- b. thousands of rubles, current prices
- c. data not available

**Source:** Sberbank

<u>Eastern Europe</u>		<u>Other</u>			
Poland	.33	Thailand	.66	Turkey	.07
Hungary	.41	Morocco	.25	Brazil	.21
Russian Fed. <sup>b</sup>	.07	Jamaica	.28	Chile	.44
		Korea	.62	Jordan	.34
		Colombia	.60	Philippines	.58
		Malaysia	.73	Tunisia	.20
		Mexico	.77	Venezuela	.24

**Notes:**

- a. Data are generally for 1990.
- b. Long-term housing loans, not mortgages.

**Source:** World Bank Housing Indicators Project and authors' calculations for the Russian Federation.

### **Developments in 1992 and 1993**

The Russian government took several steps in 1992 and 1993 to establish the legal foundation for real mortgage lending; this legislation was reviewed in Section 2. At the same time it began subsidizing housing lending in highly undesirable ways. Most recently, the Government has drafted a significant plan for the development of housing finance. Meanwhile, there were notable developments in the private banking community, including Sberbank.

#### **Deep Subsidies**

In the first half of 1992, the Government addressed the problem of reduced purchasing power of homebuyers through subsidies combined with continued use of the fixed rate mortgage. The subsidies were believed necessary to offset increases in house prices and interest rates associated with inflation: subsidies were to help sustain housing affordability. As far as we can determine, limited, if any, analysis of the full cost of such subsidies was made prior to the decision to implement the programs.

Two cases illustrate this proclivity on the part of Government. First, under Presidential Decree N.140 households purchasing a unit through a housing cooperative which began construction before January 1992 receive grants covering 70 percent of the increase in unit costs and interest rate increases. The subsidies are shared equally between the Federation and lower levels of government. Second, under an agreement among the Ministry of Finance, the Central Bank, and Sberbank effective in April, 1992 Sberbank committed to lending 30 percent of incremental liabilities for farm development and individual and cooperative housing at a 20 percent interest rate. Of the 20 percent, only 8 percent was paid by the borrower and 12 percent was paid from the Federation budget. While these loans were profitable to Sberbank in the spring of 1992, the bank estimates its 1993 cost of funds at 63 percent; hence, it will suffer large losses on all of these loans.

In April 1993 Sberbank was considering how much to increase the mortgage interest rate<sup>57</sup> and was negotiating with the Ministry of Finance about the size of the government interest rate subsidy. Interest rates will likely be over 100 percent, with some share of it financed by the budget. Such a simple increase in the interest rate while retaining the fixed rate instrument has two problems: (a) it likely offers the bank only a temporary respite from negative spreads on its loans as the cost of money is likely to continue to rise; and (b) the higher interest rate to the borrower will

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<sup>57</sup> Sberbank shifted to a mortgage contract for its long term housing lender after the passage of the Law on Collateral.

reduce the loan amount for which a borrower can qualify. A more permanent solution will require changing to some form of indexed loan instrument.<sup>58</sup>

The subsidies in both of the programs just described are poorly targeted. There are no income, unit size or other restrictions on eligibility. Indeed, a rich Muscovite who had received a free-of-charge unit through privatization would qualify for the loans being made by Sberbank.

A real concern about these governmental actions, beyond the poor targeting, is that they indicate that the government was responding to pressure by well-connected groups or by its own agencies (e.g., Sberbank) in making its funding decisions rather than having a thought-out strategy of its own. The World Bank (1992, p.77), in the context of subsidies for Russian industry, has observed the following problems with such an approach, which apply in this context as well:

- (1) Discretionary and bargained granting of new subsidies is bad for economic stabilization to the extent that it worsens fiscal and financial deficits.
- (2) This type of relationship between government and industry clearly works in favor of existing producers and their owners and managers.
- (3) Such policies tend to reinforce old patterns of influence-peddling and lobbying.
- (4) It presents the government with an acute dilemma of how to encourage and support the recovery of production without finding itself locked into underwriting the demands of a still unreconstructed industrial elite, thereby perpetuating the dependent rather than encouraging the entrepreneurial.

### **Private Initiatives**

Given the extraordinarily difficult conditions for long-term mortgage lending in Russia bankers have displayed a surprising interest in exploring the possibility of such lending. Indeed, several new institutions with the term "mortgage bank" in their names have been created. Despite these hopeful signs, we are aware of no long-term lending for housing besides that done by Sberbank.

### **New Mortgage Banks**

An unknown number of "mortgage banks" were registered in the Russian Federation in 1992. Here we report on three banks that we investigated, two in Moscow and one in St. Petersburg.

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<sup>58</sup> Some options are discussed below.

The *St. Petersburg Mortgage Bank* was selected because it had received a good deal of attention from the press.<sup>59</sup> The bank, established in February 1992, has five founders which include a commercial bank, a government agency, and three enterprises, among them a joint venture between Russian and British firms. Together they have paid in something over one-half of the Rb100 million authorized capital. As of the end of November it had not made any long-term loans, nor loans to individuals for home purchase. Reasons cited for reluctance included problems with the eviction of borrowers in case of foreclosure and the high duties for notarizing property transfers. It has only made two short-term commercial loans in which a property explicitly serves as collateral.<sup>60</sup>

The *Joint-Stock Mortgage Bank*, located in Moscow, was registered on December 24, 1992 and began operations in January 1993. Its principal share holders are five commercial banks, and other founders include an insurance company and Moscow commercial firms.<sup>61</sup> Paid-in capital is sufficient to place the bank among the largest 15 percent of banks, measured by paid-in capital. The bank will concentrate initially on commercial loans, some of which will be secured by real estate (and, therefore, will be labeled "mortgage loans"). The bank has a strong interest in originating long-term mortgage loans but has no immediate plans to begin such operations. Funds mobilization plans were under development at this writing.

Sberbank has been active in the creation of another new mortgage bank—the *Mortgage Standard Bank*. The bank was being registered in the first quarter of 1993, with its principal equity holders being Sberbank and Industrial Commercial AvtoVAZbank. Total paid-in capital from these and other founders is Rb200 million. The parent banks would be the main source of funds, at least for the first couple of years. Plans are for the mortgage bank to begin long-term housing lending as soon as it becomes operational. In the first phase of such lending, loans will be made to employees of enterprises which establish a special relationship with the bank; this relationship will entail both the enterprise keeping some funds on deposit and the bank structuring low credit risk lending programs that are affordable to enterprise

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<sup>59</sup> This description is based on material developed by Olga Kaganova in a meeting with the president of the bank, Mr. A. Vorobyev, and various written documents provided to her by Mr. Vorobyev. Not as much detailed information was obtained as desired, but Mr. Vorobyev cited "commercial secrets" as the basis of his reluctance to give additional details.

<sup>60</sup> The bank's main housing-related activity is organizing the purchase of units in inner-city buildings now containing communal flats. Purchasers of the units in the to-be-rehabilitated building make payment to the bank in advance for their unit. The bank helps obtain rights to the property, assists in arranging for sitting tenants to be relocated to new flats, and provides a construction period loan for the rehabilitation of the property.

<sup>61</sup> Information based on interview with Arkady Ivanov, President of the bank.

employees. The bank plans to use some form of an indexed mortgage instrument for its lending.

Beyond the actual developments in 1992 and 1993, several banks prepared concrete plans for the realization of mortgage lending. This section briefly describes some of these.

### **Contract Savings at Sberbank**

Sberbank proposes establishing a subsidiary which would engage in long-term housing lending using the savings of future borrowers as the source of funds. The system would be a "closed system" patterned on the Bausparkassen systems of Germany and Austria. The principal difference between this system and the one proposed for Russia is caused by the inflationary environment in which the Russian scheme would operate. The scheme designed by Sberbank is complicated, relying on a series of subsidies during the savings period to maintain the real value of the savings and potentially large interest rate subsidies during the borrowing period. The main benefit of the system is that it would mobilize household funds for use in the housing sector; from a macro-economic perspective anything that increases the savings rate is clearly helpful.

A recent analysis has computed the present value of the subsidies involved in this scheme (Ravicz, 1992).<sup>62</sup> The primary assumptions underlying the analysis are as follows. Families can devote 25 percent of their income to savings and, later, 25 percent of their income to mortgage payments. Employers are required to make an annual contribution of 10 monthly minimum wages to savers' accounts. These funds are tax exempt for the enterprise and for the saver. Families' own contributions to savings and interest earned on savings are also tax-exempt. However, the total state revenues foregone from tax exemptions for family savings and interest income are subject to a maximum yearly cap of 10 monthly minimum wages. The tax rate for enterprises is 32 percent.

To adjust for the effects of inflation, the assumptions and findings were expressed in constant, November 1992 rubles. It assumes that both participants' incomes and the monthly minimum wage increase with inflation. The monthly minimum wage is assumed to be Rb1,500 in constant terms.

Interest paid to depositors is set on a sliding scale depending on the length of the contracted savings period: at about 96 percent of the central bank base rate for families who save for 8 years and 81 percent of the base rate for those who save for

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<sup>62</sup> Note that the scheme described is as it was proposed in November 1992. It may have changed in the meantime.

2 years. For these calculations Ravicz assumed that one-half of the volume of deposits are for 2 years and one-half are for 8 years.

Loan terms also depend on the length of the savings period. Families who save for 2 years can take out a 10 year variable rate loan for a maximum amount equal to their accumulated savings, or one with initial payments not exceeding 25 percent of their income, whichever is less. Eight year savers are subject to the same restrictions with the exception that their loan term is 20 years.

The interest rate on the loan is set at the central bank base rate. Of this total amount, families pay a portion, and the government pays the rest. The interest paid by borrowers is detailed in Table 4.4. As the table indicates, as the central bank base rate declines the borrower's share of interest payments increases. When the central bank rate is 11 percent or below, there is no government interest rate subsidy. Interest rates are higher for 2-year savers than for eight-year savers.

<b>Table 4.4</b> <b>Interest Rates for Borrowers and the State</b> <b>Under Alternative Central Bank Base Interest Rates</b>		
Central Bank Base Interest Rate	Borrower Interest Rate	
	If Saved 2 Years	If Saved 8 Years
51% or Greater	22%	19%
26% to 50%	17%	14%
11% to 25%	12%	9%
Below 11%	Central Bank Rate	Central Bank Rate

Ravicz examined the contract savings program for one participant with a monthly income of Rb20,000 and one with a monthly income of Rb100,000 (November 1992 prices). The savings period is for either 2 or 8 years. Outcomes were considered under two inflation scenarios. Under the high inflation scenario, inflation is 300 percent in the first year of the contract savings program, and declines slowly to 10 percent by year 10. The central bank base rate is negative in real terms until year 7. In the low inflation scenario, inflation is 100 percent in the first year, and declines to 10 percent by year 5. The central bank base rate becomes positive in real terms by year 2.

Ravicz concludes that the program would provide savers a large measure of protection against inflation, but the cost of doing so is high. The subsidy as a share of savings would range from 41 to 60 percent for a family with an income of

Rb20,000. The family's subsidy as a share of its combined savings plus loan would drop somewhat to 24 to 54 percent. Nevertheless, a family with this income would still only be able to afford about 60 percent of the cost of a modest unit at the end of 8 years if they could afford to devote 25 percent of their income to savings and mortgage payments.

A family with a Rb100,000 income will have less protection against inflation and smaller ratio of subsidy to savings and subsidy to loan. This higher income family will have a combined subsidy to total savings plus loan ratio of from 6 to 33 percent. Nevertheless, the subsidies to this family will be much larger in absolute terms than the subsidies to the lower income family. This family will be able to afford from 230 to 298 percent of the cost of a modest unit at the end of an 8 year savings period.

In sum, Ravicz concludes that the subsidies are high and not well targeted. Furthermore, enterprises as well as the state will be required to bear this burden. Given the precarious financial condition of many firms, it appears ill-advised to further handicap them with mandatory subsidies to employees. Despite critiques of the program, housing-linked contract savings schemes were included in the draft Presidential Decree on "Development and Implementation of Non Budget Forms of Investment in the Housing Sector" as one vehicle the government would subsidize to promote housing construction.<sup>63</sup>

### **Mosbusinessbank**

In December Mosbusinessbank (MBB), one of the largest and financially strongest commercial banks, announced that it would begin mortgage lending, possibly through the formation of a subsidiary mortgage bank. Included in the announcement was the conclusion of an agreement with the U.S. Agency for International Development under which MBB will receive very substantial assistance in the creation of the lending operations during 1993. Macroeconomic conditions permitting, the target date for beginning lending is January 1994.

### ***Making Mortgage Lending Feasible: Reducing and Allocating Risk Efficiently***

Making long-term mortgage loans involves several risks. In Russia, with its volatile economic conditions and the questions surrounding eviction and foreclosure, some risks are higher than in the West for "structural" reasons. These risks can be reduced significantly—and often at low cost—by appropriate action by the national

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<sup>63</sup> Other aspects of this Decree are discussed below. At the end of March, Sberbank withdrew its proposal for a contract savings schemes until inflation declines significantly.

government.<sup>64</sup> Additionally, lenders have the ability to mitigate some of these risks, particularly interest rate and credit risks, through adopting proper practices. This section begins by discussing the various types of risk and how government could help address them. It then looks at the actions that Government and banks have taken to date in this sphere.

### **Possible Actions to Reduce Risk**

Three types of risk associated with mortgage lending are briefly reviewed below along with specific actions that could be taken by Government or banks to address them.

(1) *Interest rate risk* — the risk that the cost of funds to the lender will rise relative to the interest rate on outstanding loans, thereby causing the lender to lose money on the loans. This risk increases as the difference in the duration of the mortgages and the liabilities funding them increases. Actions government could take include the following:

- Grant affirmative permission and encourage use of indexed mortgage instruments that are suitable to inflation prone economies.
- Make necessary changes in computation of tax liability because of deferred receipt of interest income due.
- Develop reliable indexes for use with these instruments, indexes in which the public will have confidence.

The Price-Level Adjusted Mortgage, the Dual Index Mortgage, the Bulgarian Indexed Capped Credit and similar loan instrument designs were developed to work in countries with high or volatile inflation. They increase the size of the loan the borrower can take with a specified share of his income by lowering the interest rate initially paid to around 5-10 percent; the full interest rate payments are captured later because the loan principal is indexed to inflation or a cost-of-funds index. Thus these instruments shift some of the increased interest payments required on the loan into the future when the borrower will better be able to pay them because his income will be higher. Equally important, these instruments shift most or all of the interest rate risk away the lender to the borrower.<sup>65</sup>

(2) *Intermediation/liquidity risk* — intermediation risk is the risk that depositors will withdraw their funds at a time inconvenient for the bank. Liquidity risk is the

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<sup>64</sup> This section draws heavily on Struyk and Kosareva (1992).

<sup>65</sup> These instruments are described in detail in Telgarsky and Mark (1991) and Ravicz (1992a).

risk that the bank will experience a comparatively small inflow of funds, including loan repayments, compared with the demands of depositors for funds, including interest payments due. Thus, the Government could

- encourage the State Pension Fund and other government funds to purchase mortgage-backed securities at market prices.

Pension funds and insurance companies typically have a large volume of investable funds. In addition, their needs for cash can be quite accurately predicted on a year-to-year basis. For this reason they have a comparative advantage in making long-term investments. Mortgages are clearly such an investment. At the same time, there are few good investment instruments in Russian financial markets. Price or interest rate-indexed bonds or other securities based on pools of mortgages should, therefore, be a highly attractive investment. One policy could be to give pension funds and insurance companies a target for holding mortgage investments, perhaps to reach 5 percent of investments over a several year period.<sup>66</sup> To reduce this risk the government could

- establish a liquidity facility for purchase of a share of the negative amortization on indexed mortgage instruments (e.g., PLAMs and DIMs) at market interest rates.

A characteristic of the indexed loans is that they defer some of the payments due early in the life of the loan to later years when the borrower, whose income will have risen, will be in a better position to make the larger payments. Because of the deferral of the payments, the loan balance increases. The deferred payments mean that in the early years of the loan the bank has less funds with which to pay interest on deposits and to make payments to those who want to withdraw their deposits. Hence, it could experience some liquidity difficulty. Such difficulties will only occur, however, to banks that are holding a sizable share (over 30 percent) of its assets in these types of loans.

Under this proposal the Central Bank or Ministry of Finance would establish a facility to purchase from bank securities explicitly collateralized by indexed mortgage loans. In this way major mortgage lenders would have resolved their liquidity problem. The facility would base its decision to purchase the

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<sup>66</sup> These funds should, however, be discouraged from becoming mortgage loan originators, either directly or through subsidiaries. Rather, they should invest in mortgage-backed securities.

mortgage-backed securities in part on the share of all assets constituted by the indexed mortgages.<sup>67</sup>

It would be desirable for macroeconomic policy for the facility not to purchase these funds exclusively with Central Bank or government funds. The expansion in the supply of money could be controlled by the facility, in turn, selling securities to the public. The securities sold by the facility could be based on pools of mortgages from several banks (or securities bought from these banks which provide funds to the facility from the mortgage payments and repayments of principal).

(3) *Credit risk*— the risk that the borrower will not repay the loan and/or that the bank will not be permitted to foreclose on the loan. To address this issue, the government could

- authorize the lender to foreclose and create an expedited system in the courts for hearing real estate cases including default on housing loans.

Clearly, the necessity for the ability to foreclose a loan and evict the borrower in default is fundamental to collateralized lending. The Ministry of Justice could join in the first few foreclosure cases brought to the courts, and it should monitor the execution of the courts orders by the bailiff to insure that a strong precedent is established. The special system of courts will help insure that foreclosure is a reality and that real estate cases are heard by judges knowledgeable in the field.

In addition to making foreclosure a reality, Government and banks can determine the types of lending procedures that have been effective in other countries in which foreclosure is difficult or impossible but lenders have successfully dealt with credit risk. India offers a prominent example of a highly successful, high volume mortgage lender operating in a hostile legal environment by having excellent underwriting and loan servicing practices.<sup>68</sup> Furthermore, the government could

- establish a reliable registration system for land, property, and mortgage and other liens on land and property to reduce lenders' risk from clouded titles.

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<sup>67</sup> It would be simpler for the facility to purchase mortgages or participations in full mortgages, rather than to purchase securities based only on the negative amortization (so-called "strips," i.e., stripping some of the income from the mortgage from the main part). The objective to the program—to provide increased liquidity—would be realized under either option. But investors would more easily understand investments based on full mortgages.

<sup>68</sup> A description of the procedures followed by the most successful Indian mortgage lender is in Buckley et al. (1985).

### Actions to Date

In the past few months, the Russian Federation and private banks have taken a number of actions to improve the feasibility of mortgage lending, by reducing the risks involved in such lending. Below the actions are reviewed following the classification of risks employed above.

(1) *Interest rate risk.* There has been substantial interest and activity by Sberbank and Mosbusinessbank in the structuring of an indexed instrument for use in Russia. The result has been the creation of the Deferred Adjustable Instrument for Russia—DAIR. While the DAIR is based on Bulgarian Indexed Capped Credit (BICC), the design issues for the Russian instrument turned out to differ markedly from those in other Eastern European countries because of the combination in Russia of rampant inflation and a banking system with an interest rate structure massively negative in real terms.

The DAIR, like the BICC, employs two interest rates: (a) a "payment rate," i.e., the rate of interest used to compute what the borrower pays each month (typically in the range of 5-10 percent); and (b) a "contract rate," which is used to compute what the borrower owes. The contract rate for the DAIR is the interbank lending rate plus additional charges for various risks, administration, and profit. The difference between the amount owed and the amount paid each month is added to the loan balance. Payments due are recalculated quarterly using the new loan balance, and the amortization period is reduced each quarter to force the loan to close on time.<sup>69</sup>

Under the conditions existing in Russia it is not reasonable to require the new mortgage to have a positive real rate of return. Rather, the objective is to have the rate of return competitive with other opportunities available to the bank; operationally this is taken to be the interbank lending rate. Hence, the measure of profitability is relative to the bank making a series of short term loans (the whole period being equivalent to the mortgage loan period) in the interbank market. The DAIR, as designed, would yield about 140 percent of the interbank rate, and it is extremely safe in terms of credit risk (see below).

The adoption of indexed instruments is encouraged in the draft Presidential Decree that seeks to stimulate housing construction and mortgage lending.<sup>70</sup> In particular the decree would require the germane federal agencies to prepare the necessary regulations on indexed instruments, including addressing the special

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<sup>69</sup> The BICC is described in Ravicz (1992a) and the DAIR in Ravicz (1993).

<sup>70</sup> The decree is titled, "On the Development and Implementation of Non Budget Forms of Investment in the Housing Sector." It was approved in principle at the cabinet meeting of March 18. Its specific provisions are still being determined.

accounting and taxation issues raised by such instruments. The same agencies are to develop the cost of funds index(es) necessary for the actual implementation of such instruments.

(2) *Intermediation/liquidity risk.* The draft Presidential Decree moves on two fronts to address these risks. First, it would create the Agency for Mortgage Lending, which will act as a liquidity facility, purchasing mortgages from originators. The Agency will also control the quality of mortgage-backed securities issued by banks. Second, the decree would mandate that a specified share of the funds of the State Pension Fund and the State Insurance Company be invested in mortgage-backed securities: a minimum of 1 percent in 1993 and 5 percent in 1995, assuming a sufficient volume of approved securities is available.

(3) *Credit risk.* Beyond the provisions in the Laws on Collateral and Mortgage reviewed in Section 1, several additional actions have been taken that either have or will ultimately reduce credit risk. These actions can be organized into three groups.

The first is a series of actions to create and strengthen the land and property registration systems, systems that will also handle the registration of mortgages. A Government Order in August 1992 gave stop-gap directions for land registration; similar instructions exist for the Bureau of Technical Inventory to register property.<sup>71</sup> The draft Law on the Fundamentals of Land Policy reinforce provisions on land registration, and the codex will refine them further.

Second, USAID is sponsoring the work of experts with two commercial banks to introduce strong underwriting and loan servicing procedures. Over time ways will be sought to promulgate these procedures to other banks.

Third, the Presidential Decree on financing housing construction would make the Agency for Mortgage Lending responsible for creation of insurance for mortgage lenders against loan default.

Lastly, we should note the impact on credit risk of the extremely high inflation rates combined with use of the interbank lending rate as the main element in pricing indexed mortgages. With the interbank rate running at less than 10 percent of the inflation rate, it is clear that even if borrower incomes increase at only 60-75 percent of inflation, the ratio of mortgage payments to income will decline very sharply over time. Indeed, the simulations for the DAIR with a 1,500 percent annual inflation rate indicate that under conservative assumptions about income growth the ratio of mortgage payments to borrower income falls from 30 percent at origination to about

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<sup>71</sup> Enactment #622, "On Perfection of the Management of the State Land Cadastre in the Russian Federation," Issued by the Premier of the Russian Federation, August 25, 1992.

5 percent in fifteen months. In short, the particular combination of conditions in the Russian Federation have sharply reduced credit risk.

It is unclear whether some of the proposals to reduce the various risks faced by lenders will ever be realized and how effectively those that are undertaken will be implemented. That a Working Group on Housing Finance has just been established at the direction of Deputy Prime Minister and Minister of Finance Boris Fyodorov presumably increases the prospects for action.<sup>72</sup> Together these initiatives clearly point to a strong interest in encouraging the availability of mortgage credit. This interest is clearly driven by the desire to increase investment in the sector, both to increase economic growth and to satisfy popular demands.

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<sup>72</sup> This group will be chaired by First Deputy Minister of Finance Andrey Vavilov. The order establishing the group also endorsed a document containing many of the risk-control measures just outlined in the text.

## **CONCLUSIONS**

Our general conclusions can be succinctly summarized. The Russian Federation has acted with dispatch to create a legal framework in which the transition to market relations in the housing sector can develop. While additional legislation in mortgage finance and land is needed, as well as the implementing codex for the Law on Fundamentals of Housing Policy in the Russian Federation, much can be done within the current legal foundation.

Equally important, progress is being made on the realization of the transition:

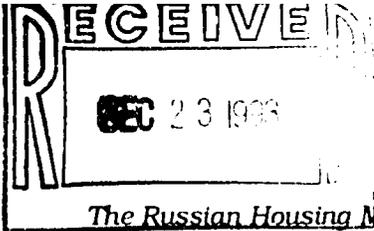
- Housing privatization is a clear success in terms of the volume of units being transferred to their occupants; indeed momentum is still increasing. A next critical step here is for regulations on the formation of condominiums to be issued.
- Reform in the rental sector is underway. The cities of Moscow and Nizhni Novgorod have been granted permission to launch experimental housing allowance programs in conjunction with increasing rents. It is likely that by the end of 1993 many cities will be implementing such programs. The most severe problem for the sector remains the improvement of housing maintenance, but this cannot begin until more revenues come from the tenants—which requires housing allowances to protect the poor.
- Regarding housing construction, even over the past two years there has been a distinct shift away from the traditional panelized construction. Official federal government policy is in favor of low-rise and cottage housing. Privatization is well underway, although the largest firms appear to be resistant. At the same time small, new private firms have increased their market share significantly.
- Russia began the transition with a particularly undeveloped housing finance system and limited number of capable bankers. Against this backdrop, there has been a surprising interest in long-term mortgage lending by both the government and the banks. The signing and passage of the draft President Decree in this area would set the stage for establishing much of the necessary infrastructure for such lending. In addition, a mortgage instrument for the Russian environment has been created. Significant lending by 1994 appears possible.

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