Housing and Communal Services in Russia: Completing the Transition to a Market Economy

Final Report

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EXECUTIVE SUMMARY

In November 2001, the Government of Russia announced the “Subprogram on Housing Reform,” calling for significant reforms of the Housing and Communal Services (HCS) Sector. The reforms are to be implemented in phases until 2010, and seek to establish market-based relationships in the HCS sector. In February 2002, the Government asked the World Bank to analyze the major issues in the HCS sector, as well as comment on the proposed reform program. The Government requested that the Bank analyze the constraints faced by local governments and the progress made in the regions. This detailed report expands upon the Short Note that was presented to, and discussed with, the Government—Ministry of Economy and Gosstroï—in June 2002. There was broad agreement on the Russian side with the recommendations and findings of the Short Note.

Sustainability of reforms requires three immediate actions that seek to improve the sector’s financial condition: raise tariffs to cost recovery levels; eliminate privileges and exemptions (l’goti) or explicitly finance these subsidies; and improve social protection mechanisms for the poor, such as housing allowances. Reforms that will reduce gross over-consumption of utility services by households and encourage production efficiency require investments, along with institutional and regulatory changes. These should also begin immediately, but will take longer to fully implement. Raising tariffs to cover costs is important to ensure that the HCS sector has adequate financial resources, while economically priced services will also provide financial incentives for both enterprises and households to achieve production and consumption efficiency.

The main purpose of raising tariffs in the short term is to ensure that the sector has adequate funding to maintain sound operations and levels of investments. As the poor will be compensated through social protection schemes, the aggregate population pays less than full costs, implying that effective cost recovery from the population will be less than 100%. As the Government will pay assistance directly to households, this will not distort tariffs from the enterprises’ perspective, and will therefore not undermine their financial condition.

Importantly, altering consumer behavior over time will also require effective housing management structures, but this critical issue is absent among the reforms listed in the Subprogram. This report highlights the importance of creating such housing management structures, if sustainability and the full benefits from reform are to be achieved. This report, therefore, is focused primarily on the role of households and the effects of reforms on consumers, rather than on enterprises and utilities, which are only touched upon.

1. KEY FINDINGS

- All cities visited have made substantial progress on improving cost recovery, but most are still well below covering full costs. Indications are that the possibilities for further cost-recovery are significant. Indeed, despite impressive recent achievements, Russia still continues to have one of the lowest levels of cost recovery of all the transition countries.
• A major constraint on reform stems from the way in which the overall system of household subsidies is financed. In particular, cost recovery and the financial viability of the sector are seriously undermined by the system of un-funded federally mandated privileges and exemptions (l’goti). L’goti subsidizes a wide range of households by taxing service providers, who respond by reducing system maintenance.

• Housing allowances programs have been established in all cities, with the objective of protecting low-income families from tariff increases. The ability of these evolving mechanisms to meet this objective needs more analysis. Nevertheless, in every location visited, the approaches adopted represent significant improvements in the targeting of the subsidy relative to l’goti. In general, housing allowances allow for a reduction in the overall level of subsidies, without reducing assistance to the poor.

• An important topic not dealt with in the Subprogram is the ability of household demand to respond to changing tariffs for services. Since housing management structures are deficient at the building level, households are unable to respond to rising prices by reducing consumption, and also unable to influence repair and maintenance decisions for their buildings. Without effective building-level management, the full benefits of reform will not be realized. The June discussions of the Short Note indicate that the Government of Russia agrees that the creation of building-level management structures is an important missing aspect in the reform agenda.

• To ensure efficient service delivery, the enterprises that supply HCS services need to be restructured and separated from municipal governments. At a minimum, their activities should be corporatized.

• Various aspects of reform are present in all cities. Since no single city has fully implemented the comprehensive set of reforms as outlined in the Subprogram, nor transformed building management, it is important that municipalities maintain their momentum for reform.

2. HCS REFORM STRATEGY

The HCS system remains a very large vestige of a non-market economy, involving fiscal transfers that are at least 4% of GDP. In the cities visited, expenditures on HCS constituted the largest budget item, ranging from 20-37% of local budgets. Almost a decade after housing privatization began, with about 60% of housing units privatized, the public sector is still largely responsible for the HCS sector. Local governments still manage and maintain virtually all of the housing stock. Due to funding shortages, the housing stock is under-maintained and infrastructure networks are deteriorating.

Reforms are politically challenging because the current system gives short-run benefits to the bulk of the population. However, recent economic growth and rising household incomes, coupled with deteriorating service, have improved the prospects for successful reform. The Subprogram identifies five reforms: (1) tariff increases to 100% operational cost recovery by 2003; (2) ending un-funded privileges and exemptions (l’goti); (3) establishment of housing allowances to protect lower-income families; (4) creation of joint-stock companies that manage and maintain housing; and (5) privatization of utility companies. Reforms that take precedence are those that address the sector’s financial condition, namely tariffs, l’goti, and housing
allowances. Longer-term reforms (4) and (5) support efficient service production, and require greater institutional and regulatory changes, such as restructuring unitary enterprises. Equally important will be measures to encourage efficiency in consumption, through the creation of housing management structures, for example. While the Subprogram is silent on the issue of building-level management, both the city visits and international experience show it is essential in the longer term to realizing the gains from reform.

A. **REFORM OF HCS FINANCE**

**Tariff Increases.** Tariff reform provides the foundation for rebuilding the HCS sector. As tariffs increase, they create financial pressure on consumers to economize on consumption and political pressure on producers to cut costs. All of the cities visited have significantly increased tariffs over the past year, and the share of costs covered by the population has increased markedly—without social unrest. Tariff collection rates exceed 90% in almost all cities visited; and, indications are that the possibilities for further cost-recovery have not been exhausted. However, cost recovery as currently defined means only operating and maintenance costs. In general, no allowance is made for depreciation or investment, with the exception of some heat and water utilities, leaving rehabilitation, upgrades and new investment un-funded.

**Reducing Un-funded Privileges.** As tariffs have increased and consumers have maintained high payment rates, the problem of l’goti has become more apparent. The system of l’goti mandated by the Federal Government reduces payments from large numbers of consumers defined on the basis of professional and social characteristics, rather than actual need. Enterprises experience significant revenue shortfalls due to l’goti, and local governments typically lack the cash to fill the gap. L’goti undercuts good tariff policy, starving HCS of funds. A resolution of the l’goti system is a prerequisite to addressing the arrears problems that plague the sector. Within the context of the HCS sector, though, the system of housing allowances, if well targeted, will allow for low-income families to be protected even if l’goti is eliminated.

**Housing Allowances.** Housing Allowances provide social protection that can help low-income families afford tariff increases. As tariffs have risen, so too have the demands for housing allowances. The city visits found that local governments have adopted many variants of this form of assistance, and a systematic review of practices across municipalities, and their links to other social protection programs, is now warranted. As tariff increases continue, the importance of housing allowances as a social protection mechanism will rise, population coverage will expand, and administrative demands will increase.

B. **INSTITUTIONAL REFORMS**

**Creating Household Demand.** If the full benefits from increasing tariffs are to be realized, household demand must be able to respond to changing tariffs. Pricing for HCS therefore has to be based on actual consumption, rather than norms, but except for electricity, the cost of metering individual apartments is prohibitively expensive, and a more practical solution is block metering of buildings. In order for costs to be shared out to individual apartments, though, building-level management structures—such as homeowners’ associations (HOAs)—will have to be created. Without HOAs, households’ reduction in consumption in response to rising tariffs
Housing Maintenance Companies. The chief problem with existing housing maintenance companies is that they face no effective pressure to improve service quality. Maintenance is priced on a normative basis; i.e. by square meter or number of rooms, and there is therefore no link between the maintenance tariff and the quality and quantity of services provided. Unless such a link can be developed, the maintenance market will not deliver services to the degree that would allow significant improvements of the current housing stock. In order to encourage a competitive market in building maintenance, the strong link between municipalities and service providers also needs to be broken. However, local authorities seem reluctant to relinquish direct control over enterprises. This is partly due to the fact that authorities fear a vacuum in service delivery if they break up maintenance companies. The result is a continuation of current operations, with no real efforts to encourage private competition in delivering maintenance services. Even where joint-stock companies have been formed, firms do not compete in any real sense; rather, they share the existing market through long-term contracts that stifle competition.

Utility Regulation. In order to make further progress, adequate regulation of local service providers must be in place. Although regulatory bodies have been formed, in most places they are not sufficiently responsive to changing economic conditions, often failing, for example, to provide timely adjustment of local tariffs to reflect increases in energy input prices. Furthermore, cities complain about the lack of guidance from the Federal Government on the regulation of local monopolies, such as water and district heat.

C. MAINTAINING REFORM MOMENTUM

All of the cities visited have begun to reform various aspects of their HCS sectors, and all local governments have started to address the sector’s financial condition. But, without continued tariff reforms and improved targeting of social protection, there will be little scope for reducing subsidies and strengthening the sector’s financial integrity. No single local authority has managed to fully implement the comprehensive set of reforms listed in the Subprogram. There is scope for cities to learn from each other’s experiences, and to assess the feasibility of implementing reforms locally. It is important that cities maintain the reform momentum they have established, and that the Federal Government creates an environment that supports their efforts.
I. REFORMING THE HCS SECTOR

The housing and communal services (HCS) sector is one of the least reformed and most inefficient in the Russian economy, and represents the last sector that will require serious reforms if Russia is to complete the transition to a market economy. Services in the HCS sector continue to be delivered by local governments in much the same way as they were during the Soviet era, with virtually no reliance on market-based mechanisms. Numerous attempts to reform the sector have failed due to political circumstances and unforeseen economic shocks, the last one being the 1998 financial crisis. During the unstable macroeconomic environment of the 1990s, the HCS sector acted as shock absorber. The housing stock and utility networks were allowed to depreciate as maintenance and investment funds were diverted elsewhere by cash-strapped households and local governments. Recent stabilization of the macroeconomy and rising household incomes have greatly improved the prospects for reforms in the HCS sector, which includes rent, housing management and maintenance, water, sewerage, gas, electricity and heat.

This paper is divided into four sections. The first outlines the history of housing reforms, explaining how and why previous attempts at reforms were stalled. Making use of information gathered during the city visits of April 2002, the paper describes the general conditions that currently make it possible to pursue reforms. The second part describes Government’s reform priority areas, outlining and discussing the three immediate reform areas aimed at improving the sector’s finances; namely tariff reform, the system of privileges and exemptions (l’goti), and implementing a system of social protection, such as housing allowances. The third section focuses on the major reform efforts required over the longer term, identifying the following three broad areas: (i) creating housing management structures; (ii) redefining institutional relationships between local governments, enterprises and consumers; and (iii) municipal enterprise restructuring. The final section deals with intergovernmental relations with regard to financial flows and tariff setting responsibilities. The central focus of this report is on the role of households in the reform process, and the impacts of reforms on consumers. While also important, the role of enterprises and utilities are only touched upon.

1. METHODOLOGY

This paper identifies the major reforms that will be required in the HCS sector if it is to transition from a system based on government delivery to one where markets play an increasingly important role. The analysis in this paper is based on extensive economic and sector work previously done at the World Bank, as well as the experiences from World Bank housing, energy, and water projects. It also builds upon previous work by Russian Institutions, and the Federal Government’s recent “Housing Reform Subprogram,” all of which have focused almost exclusively on reforming the sector’s finances and municipal enterprise restructuring. An important contribution of this paper is to highlight the need to have household demand respond to changing tariffs, by creating building-level management structures, such as homeowners’ associations. Without reform of housing management structures, the benefits of reform will be
attenuated, as households’ responses to price changes will abate, and their ability to put pressure on service providers to improve efficiency will be hampered.

This report complements previous research efforts based largely on fieldwork completed in April 2002. Three teams consisting of World Bank and Russian experts visited a total of thirteen cities to investigate the state of the HCS sector at the sub-national and municipal government level. The list of cities visited is provided in Table 1 below. The cities were selected based on a variety of criteria, most importantly: degree of reform to date, level of income, population size, and level of cost recovery. Due to resource constraints, the city visits were limited to three Federal districts: Northwest, Central and Volga. Each team used a common questionnaire to structure and guide discussions and, to the degree possible, also visited the same set of institutions.

Table 1: Municipalities Visited (April 2002)

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<th>Region</th>
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<th>Oblast</th>
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<td>Samara Oblast</td>
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<td>Ulyanovsk</td>
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<td>Dimitrovgrad</td>
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<td>Yoshkar-Ola</td>
<td>Marii-El Republic</td>
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<td>Central</td>
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<td>Maloyaroslavets</td>
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2. REFORMING HCS IN THE TRANSITION PERIOD

Current conditions in the HCS sector appear to be worse than implied by the general macroeconomic situation. The HCS sector accounts for more than 50% of the country’s fixed capital stock, and constitutes perhaps the largest sector in the Russian economy still operating along non-market principles. The existing housing stock is under-maintained, and utility services are poor in quality and expensive to produce. The housing stock and infrastructure networks are steadily depreciating due to a general lack of funds for maintenance and repair. Tariffs paid by consumers do not even cover operating costs, let alone maintenance and capital investment.

A. HOUSING SECTOR AND THE MACROECONOMY

The housing sector plays an important role in every country's economy, while also acting as a potential tool for sustaining and promoting overall welfare and development. The housing sector typically accounts for 10-20% of total economic activity, and housing investment constitutes 2-
8% of GDP. In Russia, housing investment constitutes roughly 3-4% of GDP. In order for the housing sector to effectively play its role in the national economy, housing reforms are pivotal for countries during the period of transition from centrally planned to market-based economic systems. Plagued by highly subsidized housing sectors, transition countries have required urgent restructuring in order to cope with financial shortfalls and rapidly depreciating housing stocks and infrastructure networks. The large-scale and pervasive under-pricing of inputs generates problems with maintaining the sector’s financial viability and leads to large flows of subsidy transfers.

In general, HCS subsidies remain largely unaccountable and unmeasured in Russia. Various studies have indicated the fiscal and quasi-fiscal transfers that result to be at least 4% of GDP. Freinkman (1998) places explicit budget subsidies for housing and related utility services at about 3% of GDP, with cross-subsidies from industrial users to households and from utility enterprises to households accounting for another 1%. The chronic under-funding of enterprises also results in the piling up of arrears in the sector. Pinto et al. (2000) estimates the implicit subsidies resulting from non-payments from the energy monopolies alone to be about 4% of GDP. Federal Government estimates place subsidies in the form of privileges and exemptions at about 1% of GDP. High subsidies to the HCS sector are also reflected in the fact that Russian households on average spend only about 6% of their income on housing and utility services. This is much lower than the transition countries of Eastern Europe. For example, households in Poland and Hungary typically spend over 20% of their income on HCS. More work is needed on estimating HCS subsidies (implicit and explicit) at the macroeconomic level, as well as on disentangling the nature and incidence of subsidies at the municipal level.

After the turmoil in the late 1980s and 1990s, Russia followed the move of the other transition countries in the Eastern Europe toward critical structural change of its economy. The contractions that accompanied the transition process meant that government expenditure had to be greatly reduced. With macroeconomic stability becoming the prime objective, the only solution to the housing problems at the time appeared to be delaying investments in the existing capital stock. Initial privatization of the housing stock made only modest progress, as it was based on the assumptions of market conditions valid for the western countries, but not for newly post-Soviet Russia. Privatization was hampered by a number of problems ranging from poor coordination between the reforms of the housing and other sectors, to inadequate institutional and regulatory structures, to a series of crises in the 1990s, leading to repeated collapses of the Russian economy.

While Russia has established macroeconomic stability, the shift to a market-based economy is still incomplete in the housing and communal services sector. Local governments continue to assume prime responsibility for the HCS sector, managing and maintaining virtually all of the housing stock. In the cities visited, expenditures on HCS ranged from 20% to 37% of local budgets, constituting the single-largest budget item. Reorganization of the public housing stock is still a major necessity of the remaining reforms. Evident today is the need to do so with improved protection for the poor, especially as tariff increases are central to the financial viability of the HCS sector. Reform of the HCS sector is seen as an important component of what has recently been viewed as the second generation of reforms; that is, the sector-specific
reforms that are required for sustainable long-term growth once macroeconomic stability has been achieved.

B. A Brief History of HCS Reforms

Numerous housing reform initiatives have been introduced during the past decade, all with the intention of moving this sector to a more market-based system. The recent Federal Government initiative for reform, as stated in the Subprogram, is aimed at implementing market-based transaction mechanisms in the supply of housing and communal services—i.e., from housing management and maintenance to utility reform. The view underlying the Subprogram is that the macroeconomic crisis stalled the reform process for HCS, but the pace would again accelerate when macroeconomic conditions improved, and the financial burden became more bearable for the populace as real incomes rose.

The housing privatization reform agenda was initiated a decade ago and designed as a free distribution of existing units to sitting tenants. Tenants were given an open-ended option to privatize their units; that is, privatization was made voluntary. A household would now own the structure debt free, and thus have no current cash rent (or debt) obligation, and household cash payments would be limited to repair, maintenance and utilities. The unit would be freely tradable to facilitate mobility and to allow households to adjust consumption to be consistent with tastes, income and wealth. Households would have the incentive to maintain, repair and upgrade, and to economize on utilities. However, no real incentives existed for households to privatize, as rents and utilities are highly subsidized, renters enjoy a high level of protection as there are virtually no evictions, housing management and maintenance are still provided by municipal enterprises, and the market for trading units is still very thin. While the privatization process has been slow, over 60% of apartments are privatized.

Housing privatization was intended to shift the burden and control of the HCS sector to consumers, who would have the incentive to economize on resources and invest in their own housing. The presumption was that tenants would form building-level management structures. In fact, the initial privatization of apartments also coincided with a severe inflationary recession, with incomes falling 30% and annual inflation exceeding 1,000%. Due to this shock, households were unable to accommodate larger expenditures on HCS, and unadjusted household expenditures on HCS fell to less than 1% of income. Correspondingly, local governments continued to manage and maintain the housing stock. Given the large utility subsidies and substantial maintenance needs, households were content to leave responsibility for the building shell and public spaces with local governments.

The housing stock effectively remains public housing from a repair, maintenance, upgrading and utilities perspective, regardless of the percentage of apartments that are privatized. The municipality is still viewed as the owner of the building and property, and municipal enterprises continue to provide maintenance, repair and rehabilitation—generally at inadequate levels due in part to lack of funding. Even if households are willing to spend more on maintenance, there is no incentive or payment mechanism at the building level. Participation in homeowners’ associations for privatized flats is optional, resulting in a lack of participation by all households.
within a building. Hence, the privatization of the housing stock did not move the HCS sector towards a functioning market.

Since early in the transition period, the Federal and local governments have viewed housing allowances as an important means of protecting low-income families as rents and tariffs rose. The slow pace of housing reforms throughout the 1990s meant that the system of housing allowances was not fully rolled out across municipalities, and also did not appear very effective, as population coverage was very low. Early assessments of the housing allowances program show moderate participation rates, as well as low average benefit levels, due in large part to the fact that rents and tariffs had not risen significantly enough to affect household budgets. An initial assessment of the performance of the housing allowances program was conducted in the cities of Gorodetz and Vladimir, based on households surveyed in 1994 and 1995 (Struyk, Puzanov and Lee, 1997). The study highlights the importance of a better information campaign in informing people of the need for rent increases and the existence of a social protection program that ameliorates the effects of the rent increases on poor households. Information programs can potentially reduce the resistance of the population to rent increases and promote the reform program.

Other efforts to reform the HCS system have been attempted, but again, these were derailed by serious and extensive wage arrears in 1996 and the macroeconomic crisis of 1998. Given the circumstances, the relative prices charged for HCS actually decreased in favor of continued reliance on public enterprises for the provision of services. Local governments chose not to confront households with prices that might not be affordable at the time. The general economic contraction also meant that a lack of competing firms emerging would not cause price increases for HCS services to induce a shift in demand away from existing municipal companies. Under these circumstances, many tenants chose not to privatize their apartments, and the owners of individual apartments never sought control of their buildings, nor did municipal governments relinquish their role of management and maintenance.

3. CURRENT SITUATION IN THE HCS SECTOR

Numerous housing reforms have been introduced during the past decade, but recent reform initiatives, as spelled out in the Subprogram, have honed in on housing services and communal enterprises. The Subprogram is focused on moving the HCS sector as a whole to operate along market principles. Key problem areas facing the sector are: low levels of cost recovery throughout the system; large-scale subsidization of HCS services in a non-sustainable system, exacerbated by the sharp drops in local government budgets and contractions in the real incomes of the population during the transition crises; rapid deterioration of the existing housing and utility infrastructure stock due to inadequate maintenance and repair, resulting from a general lack of funds; and extreme monopolization and centralization of the sector. Some areas of reform have gained momentum recently, such as tariff increases and improved social protection.

The HCS sector has come under increasing financial pressure because tariffs charged to consumers remain low, and price liberalizations in other sectors have raised the nominal costs facing producers in this sector. This has led to continuing large subsidies and payment arrears to
the unitary enterprises that provide HCS services. Hence, the immediate priority for the housing sector, on the part of the oblast and municipal governments that own these unitary enterprises, has been to substantially raise rents and utility tariffs. This action is a first step toward restoring the fiscal integrity of the HCS producers. In fact, in all the cities visited, significant tariff increases have been realized without inordinate unrest or indignation. Household payment rates have remained high, in most cases above 95%. Mayors reported that, in general, the population has been quite accepting of tariff increases. In other words, households appear willing to accept price increases, much as they have in other FSU countries.

4. PROSPECTS FOR HCS REFORMS

The prospects for reform are currently more favorable than they were in the past for two reasons. First, economic growth and greater stability have been achieved, thereby lessening the concerns about higher household payments for HCS. Despite macroeconomic stability and sound growth since 1999, the pace of HCS reforms is still slow. The economic environment is currently suitable for pursuing reforms, but there are risks that the reform momentum gained over the last two years will slow down. Currently improved local fiscal accounts, however, may lead to a degree of complacency in tackling reforms. It is important that the reform momentum be maintained, since HCS reforms are difficult to implement in tough economic times, especially those that require redirecting of subsidies and affect household budgets.

Second, the experiences of other FSU economies, particularly the Baltics, suggest that rapid price increases are quite feasible. Unlike Russia, these small countries had no domestic energy supplies, and correspondingly, had to pay market prices for utilities. As a result, they were compelled to move more rapidly to full cost recovery for utilities. Like Russia, these countries also experienced deep economic downturns, and in the immediate aftermath of these shocks they, too, were unable to adjust energy prices to reflect resource costs. After establishing stable growth, however, they all moved quickly to full cost recovery, while also establishing housing-related safety nets, so that the price increases could be absorbed without undue burdens on the poor. Moreover, the public costs of these safety nets are a fraction of those that result from price ceilings as used in Russia.

In addition, in November 2001, the Federal Government announced its comprehensive Subprogram for “Reform and Upgrading of the Housing and Utilities Sector in the Russian Federation for 2002-2010.” Among the central objectives of HCS sector reform, as stated in the Subprogram, are the improvement of the overall efficiency of the sector and attraction of investments. These goals will be achieved through the reform of the basic market relations constituting the sector, including the reform of the enterprise ownership structure. At the same time, given the existence of such fundamental constraints to reform as the un-funded system of privileges and exemptions (l’goti), it is clear that reform of the market relations and enterprise ownership structure are necessary, but not sufficient conditions for the attainment of the stated goals of the Subprogram.
II. IMMEDIATE REFORM PRIORITIES: FINANCIAL VIABILITY OF THE HCS SECTOR

The HCS sector represents the complex nexus of many markets. In addition to providing the connection between consumers and enterprises, the sector is also heavily influenced by local government actions and involvement. The Subprogram provides a focus on HCS reforms, and describes the main issues facing the housing sector and its causes: “The critical condition of the housing and utilities sector is explained by its inefficient management system, the sector’s dependence on public subsidies and poor financial situation, high costs, lack of economic incentives to lower the costs of providing housing and utility services, underdeveloped competitive environment, and as a consequence, by a high wear and tear of its fixed assets, inefficient performance of service providers, and heavy losses of electricity, water and other resources” (page 6). The proposed reforms seek to introduce greater reliance on market-based transactions in the delivery and consumption of HCS.

The Subprogram focuses the prospective reform effort on the supply of housing maintenance and communal services (utilities). Regulatory and institutional reforms will be needed to redefine both local governments’ role and that of unitary enterprises if efficiency in service delivery is to improve, and if HCS enterprises are to attract private capital for investment purposes. This section will focus on the immediate reform priorities that are already in the process of being implemented; that is, reforms aimed at improving the immediate and long-term financial viability of the HCS sector. As a first step, these reforms seek to improve enterprise finances by raising tariffs to improve cost recovery, while also aiming to reallocate subsidies from producers to consumers, so as to better target subsidies to the poor. The reforms dealing with tariffs, subsidies and social protection take priority, and form the key set of initial reforms to be pursued immediately by local governments.

1. PRIORITIZING REFORMS

The Federal Government’s Subprogram identifies five reform priorities: (1) increasing utility prices to cover all operating costs by 2003; (2) eliminating un-funded privileges and exemptions (l’goti); (3) establishing a system of housing allowances to protect lower-income families; (4) creating joint-stock companies to manage and maintain housing blocks; and (5) privatizing utility companies. The Subprogram says nothing, however, about the creation of effective housing ownership and management structures, which is very important if reforms are to succeed in altering institutional arrangements between consumers and enterprises and between households and local governments in a lasting manner. Both the city visits and international experience show that effective organization of the demand side, through the creation of building-level ownership structures that make apartment owners responsible for managing and maintaining their own buildings, is essential to realizing the potential gains from reform.

Reforms that should take precedence are tariffs, l’goti, and housing allowances, or (1) to (3) of the Subprogram. If the full benefits from increasing tariffs are to be realized, they must be accompanied by the ability of household demand to respond to changing tariffs, which currently
in Russia can be achieved through creation of effective building-level management structures. While also very important, reforms (4) and (5) will take longer to implement. In fact, reforming housing maintenance and utility companies offers few gains without the establishment of appropriate regulatory frameworks and implementation of institutional reforms. Utility restructuring and ultimate privatization will help achieve production efficiency only once price problems have been solved and tariffs reflect economic costs.

Successful HCS reform requires two initial conditions: first, enterprises have sufficient revenue to cover at least operation and maintenance costs; second, consumers are willing and able to pay the costs of services charged to them. On the revenue sufficiency side, only continued action on tariffs and privileges (l’goti) will provide the resources needed to address the HCS financing gap. Consumers will be willing to pay the higher tariffs only as long as they feel services are priced fairly, and they observe increases in the quality of services delivered, or they feel that prices charged reflect the level of service quality provided. In addition, consumers who cannot afford the rapid rise in tariffs need to be protected by targeted social assistance programs, such as housing allowances.

A. Tariff Increases

The most immediate and perhaps most contentious reform is raising tariffs charged by municipal enterprises to the population for all HCS services. Local authorities have two legitimate concerns, namely the ability of the population to afford price increases, and potentially negative reaction on the part of consumers to rapidly increasing tariffs. In many cities, until recently, tariffs were extremely low, with cost recovery levels of 30% not uncommon. The Subprogram estimates that in early 2001, tariffs in Russia were set to recover about 60% of costs on average, but in reality household payments covered only about 40% due to various subsidies. This places Russia’s cost recovery for HCS lower than most of the transition countries in Eastern Europe.

Only tariffs set at full cost recovery levels will ensure financial sustainability, as they will provide enterprises with sufficient funds to sustain efficient production. It should be noted that cost recovery from the population will effectively be less than 100%, as not all segments will pay the full cost of the tariff. Poor households should be compensated through social protection schemes, as is currently being implemented throughout Russia. Subsidies will therefore be shifted from enterprises to direct payments to households. Maintaining below-cost tariffs is an across-the-board subsidy to all households: they benefit better-off households disproportionately and are highly regressive. Direct subsidies to households are more equitable, as they target the subsidies to needy households and force those who can afford it to pay the full tariff. Also, eliminating artificially low tariffs removes price distortions faced by enterprises and ensures that they receive sufficient funding to cover their costs.

In 2001, municipalities throughout almost all of the Russian Federation raised tariffs sharply. While there has been some negative reaction in certain places, problems only seem to have arisen where the population had not been adequately informed of the upcoming tariff increases. This was the case in the much publicized protests against tariff increases in Voronezh. Most localities have managed to raise levels of cost recovery, often through rapid tariff increases. In
Dimitrovgrad, for example, tariffs were raised from covering 8% of operating costs in January 2001 to 70% by July 2001, with plans to reach 90% in the autumn of 2002.

Nevertheless, despite the rapid tariff increases, in most cities, the levels of tariffs are still well below what would be required for full cost recovery. Annex 1 contains the cost-recovery data for all thirteen cities visited. In many municipalities, setting tariffs at cost recovery implies: (i) only charging for operating costs in the case of housing management and maintenance, and (ii) in the case of utilities, particularly water, tariffs charged reflect operation and maintenance costs. Tariffs for utilities are expected to not take into account capital repair costs, and only in rare circumstances are utilities given a tariff that includes an allowance for depreciation, which in Russia is considered a profit margin. Housing management and maintenance tariffs do not include charges for capital repairs, and only recently have some local authorities begun to charge households for these. The difficulty with building repairs, especially common property areas, is in assigning costs to tenants. Hence, most capital repair costs for buildings are not recovered, leading to under-maintenance of the housing stock.

According to city officials, in no place visited has the potential for raising tariffs to full cost recovery been exhausted. Even in Cherepovets, where official policy is to cover 100% of costs, tariffs cover both operating and maintenance costs for utilities, but only operating costs for housing maintenance companies, with capital repairs and maintenance costs excluded. Thus, there still scope for increasing tariffs in Cherepovets to cover repair and maintenance of the housing stock. In some cities, tariff increases run the risk of losing momentum, as some politicians are averse to raising tariffs too much, while others view their goal as achieving the Federal Government’s target of covering 80% of costs, as specified in the Subprogram. In Yoshkar-Ola, for example, cost recovery is currently at about 67%, with no clear plan for attaining full cost recovery.

Local authorities are aware that the current situation is unsustainable. In general, people are more accepting of tariff increases when local governments have engaged in campaigns informing them of the necessity for tariff increases. In Ulyanovsk, between 1998 and 2000, tariffs remained unchanged at a very low level of cost recovery, 30%. This led to accumulated arrears to heat and energy suppliers that exceeded the local government’s annual budget. As a result, housing and utility networks were not maintained and continued their depreciation apace. The very poor condition of the networks, coupled with the inability to pay energy suppliers, resulted in the housing and budget organizations being severely under-heated during the last two winters. The city Duma faced pressure from the Federal Government and increasing tariffs was set as a condition for Federal financial support. Cost recovery was increased to 52% in 2001, with no negative reaction from the population, and further increases to 80% are under review. According to local officials, after the experience of the last two years, consumers would be willing to pay full costs if it meant no service interruptions.

Although almost all municipalities have raised tariffs, cost recovery policies are not consistent across the country. Cherepovets and Otradnyi have similar, relatively high levels of prosperity. Yet, in Cherepovets, tariff increases have been much more aggressive, with full cost recovery the official city policy. The city Duma in Otradnyi is very cautious in raising tariffs, and cost recovery is currently at 50% for heat and 55% for other services. In Otradnyi, the pressure from
the enterprises is relieved because the budget provides a large share of the funds not collected from the population. While Cherepovets could follow a similar policy, the local authorities prefer to encourage greater efficiency in consumption by making consumers pay the full operating cost of services and maintenance for utilities, while also trying to place pressure on utilities to be more efficient.

B. REDUCING UN-FUNDED PRIVILEGES

The Federal Government’s 2000 Economic Program identified the system of un-funded privileges and exemptions (l’goti) mandated by the Federal Government as a needed reform area. L’goti is to be replaced by the development of a well-targeted regional poverty benefit program. The current subsidization of HCS keeps the price of services delivered below economic levels for all consumers. This implies that households that consume larger quantities are receiving greater subsidies.

The problems stemming from l’goti have become much more apparent, especially as tariffs have been raised rapidly throughout the country. L’goti is automatically deducted from consumers’ bills and households typically receive a subsidy of roughly 50% for rent and communal services. A recent study by Misikhina (2002), based on 2000 Goskomstat data for six regions of Russia, revealed that nearly 40% of all households received discounts in housing payments due to the privileges and exemptions, the main recipients being pensioners and medium- to high-skilled civil servants. Despite growing evidence that l’goti is not targeted to the poor, this reform has not met with political support, perhaps precisely because it has large coverage and benefits mostly the non-poor.

By law, enterprises are to be compensated for l’goti from the Federal budget, but the system is severely under-funded by the Federal Government. Local governments also typically lack the cash to fill the financing gap. L’goti therefore acts as a tax on producers, undercutting good tariff policy, and depriving the HCS enterprises of funds. As a result of the l’goti system, even when tariffs are raised to cover costs and consumers maintain high payment rates, as they have been doing in almost all cities, enterprises still experience revenue shortfalls due to the under-financing of l’goti from the Federal budget. In Cherepovets, for example, tariffs have been set at levels that allow for virtually full cost recovery if everyone pays the full bill. The system of l’goti acts to reduce payments from the population, and hence cost recovery, to about 70%. The municipal government finances an additional 12% of costs from its own budget, and the remaining 18% goes un-funded.

In all the cities visited, regardless of the level of tariffs, once un-funded mandates, such as l’goti, are taken into account, the share of costs recovered from the population automatically dropped roughly 20-30%. The Subprogram states that in early 2001, when households were paying about 60% of housing and utility costs, adjusting for l’goti reduced actual household payments to 40% of costs. On a national average basis, tariffs set to recover 100% of operational costs would therefore cover no more than 70-80% of full operating costs once l’goti was subtracted. The revenue shortfalls also appear as arrears between municipalities and enterprises, which are deprived of much-needed funds. Fixing the arrears problems that plague the sector will require a resolution of the l’goti system.
Under the l’goti system, non-poor households receive a larger percentage of social protection resources than do the most vulnerable groups. Assessing the performance of housing allowances at the national level using the 1995 RLMS dataset, Wilson (1999) found that housing subsidies (such as l’goti) that are applied uniformly across the population, over-compensate high-income households. Based on the 2000 RLMS data, Posarac and Rashid (2002) also show that low-income households receive a much lower share of the rent and fuel subsidies compared to higher-income households. In sum, poor households currently spend larger portions of their income on HCS and receive a smaller share of the total subsidy.

C. HOUSING ALLOWANCES

The system of housing allowances is intended to target families with low incomes, and to prevent poor households from spending excessive shares of income on HCS. The housing allowance subsidy is set equal to the gap between a defined maximum social rent (MSR) and a fixed percentage of household income and actual rent charged. Housing allowances are means tested, so that individuals above a set income threshold are ineligible for subsidies. The income thresholds varied among the thirteen cities visited (see Annex 1, “Burden Limit” column). Currently, the coverage rates for the housing allowance program are far lower than for l’goti. According to Misikhina (2002), for recipient households, housing allowances are a slightly larger share of net disposable income relative to l’goti, but have very low coverage overall. The low coverage rates were further confirmed by the city visits (see Annex 1).

The system of housing allowances is complicated by the use of an alternate formula—the “second basis”—for households with incomes below the subsistence level, when the income threshold can be set equal to half the minimum wage for each household member. The subsidy is therefore equal to the MSR less this amount. Given the very low minimum wage, this could make the subsidy level quite high and expensive if participation rates are to increase. The fact that the minimum subsistence level (an absolute poverty line) is sometimes set very high relative to average family incomes in particular regions exacerbates this problem. The use of two different formulas makes the administration of the system quite complex. In some cities, such as Ulyanovsk and Dimitrovgrad, the minimum wage-based formula has been eliminated because of its high costs.

Cities have various institutional arrangements for paying housing allowances, and housing allowances are being paid through a large array of different offices—for example, local administration social assistance offices, separate housing allowance offices, in a municipal maintenance organization, or within an enterprise. The latter two options are not optimal because they deprive the local administration of any overall picture of program implementation or control over enforcement or compliance with standards. Making housing allowance payments a function of social protection bodies was the preferred option in many of the cities visited. The merger of benefit payments into a single social protection office provides greater conformity of benefit provision and greater coverage of the population. For this reason, changes along these lines are under way in some cities, such as Cherepovets.
As with other income-tested programs, the housing allowance scheme can be complex to administer. Offices are often inadequately funded (payroll, equipment, premises), which leads to long waiting lines and lower-quality services. Monitoring of claims and checks of eligibility vary across offices. Some offices only check documents, while others institute hard checks, with officials randomly visiting apartments and coordinating with tax authorities, as in Ulyanovsk. Other offices make no checks at all, as is the case in Dimitrovgrad, Yoshkar-Ola, and Otradnyi. Some municipalities in all three Federal districts visited, such as Tikhvin and Murmansk in the Northwest, did not have sufficient budgets to pay for housing allowances. Household income is not easy to measure in Russia, which makes under-stating income possible in order to increase the size of the allowance, thereby making it more difficult to target the poor.

To date, the combined sources of housing subsidies have not been particularly well targeted to the poor (Lovei et al., 2000). In the current Russian context, the system of housing allowances presents an improvement over subsidies like l’goti, but the program’s coverage still remains low. Greater public information campaigns about the program and improvements in delivery remain important. The methodology for targeting allowances has scope for improvement, especially elimination of the minimum wage-based approach. However, further analysis with more recent national-level survey data is required to confirm the targeting efficiency of the expanded housing allowance programs. Within the context of the HCS sector, though, the system of housing allowances will, if well targeted and implemented in concert with other social protection programs, allow for low-income families to be protected, even if l’goti is eliminated. In all the cities visited, it is clear that a desire exists to implement a program of housing allowances.
III. LONGER-TERM REFORM STRATEGY: REDEFINING INSTITUTIONAL RELATIONSHIPS

Under the Soviet system, housing management and maintenance, along with utility services, were delivered by local monopoly enterprises. As a result, housing and communal services were defined as a sector largely because of this feature. Even under the Soviet system, the companies were divided into those providing housing management and maintenance, and the various utilities, respectively. While the utilities portion of HCS has elements of natural monopoly, that characterization does not apply to housing management and maintenance companies. Indeed, the nature of maintenance, repair, and rehabilitation services lends itself to a competitive market for such services. In fact, reforming housing management and maintenance services constitute the most challenging aspect of the HCS reform program to municipalities. Attracting private-sector investments also presents a key challenge to the HCS sector, especially given recent experiences with system failure during winter. While there is indication of growing interest among private investors in Russia, a key challenge is attracting large-scale investments—Russian, foreign, and international financial institutions—into the HCS sector.

The Subprogram recognizes this distinction in outlining proposed reforms management and maintenance of the housing sector versus the utilities sectors, but the Subprogram needs to be refined and focused more effectively on these two distinct areas of HCS delivery. Unless such a distinction is clearly made, reform of the various segments of this sector will be problematic because institutional relationships will continue to be blurred. Following the Subprogram, this section will detail the longer-term strategy of restructuring unitary enterprises. While full enterprise reforms will take a long time to implement, it is important that local governments start this process as soon as possible. A discussion is added first on reforming building management structures, even though this is not highlighted in the Subprogram. This is important, as creating effective building management structures will be instrumental in altering household behavior vis-à-vis efficient consumption and demanding quality services from providers. No municipality has managed to significantly improve housing management. Almost no reform has been implemented in this sphere. Rents are still very low, and no progress has been made on creating building-level management structures, which are crucial to the success and sustainability of the reform program.

1. HOUSING MANAGEMENT AND HOUSEHOLD DEMAND

The relationship between consumers and local governments in the HCS sector is indirect, as the subsidies are funneled through enterprises. Since prices charged to consumers are generally well below resource costs, people have no incentive to retrofit highly energy-inefficient housing units or conserve energy in other ways. Subsidies given to enterprises to offset rising input prices are also dissipated through wasteful water and energy usage by both households and suppliers, as prices do not affect household consumption levels. Losses in water and heat are pervasive in both the networks and in apartment blocks. Unless the costs can be share out to individual users, it will be difficult to cut back on the gross over-consumption by households. Creating building-level management structures, such as homeowners’ associations (HOAs), serves two purposes: first, management responsibility for the building is transferred from local governments to
tenants; and second, costs can more easily be shared out to users in a building, thereby creating an incentive for users to reduce consumption in response to rising tariffs.

A. LOCAL GOVERNMENTS AND HOUSING MANAGEMENT

Local governments currently assume the responsibility on behalf of households for managing virtually all of the housing stock. Local authorities are reluctant to relinquish responsibility for the housing stock, as they fear disruptions in service delivery due to any reorganization of municipal enterprises. Local governments remain skeptical about the benefits that could result from splitting housing management and maintenance functions, precisely because no institutional structures exist at the household level that will allow individuals to manage their own buildings. The absence of building-level management structures also means that individual households lack the ability to contract directly with smaller, private service providers for maintenance. This contractual function can generally be performed by an HOA, for example, but absent such bodies, local governments effectively contract municipal enterprises on behalf of households.

Households also face constraints in forming HOAs. The first problem is that it is voluntary for individual households to join and HOA. This creates a free-rider problem, where some households expect to benefit from an HOA’s activities, but do not feel inclined to make any financial contributions to help with the operation of the building’s management structure. Also, as long as households perceive that the local government is responsible for the building, they will be reluctant to contract separately with provide companies, or even with the municipal enterprise. The implicit disaster insurance provided by municipalities may contribute to households’ reluctance to give up the implicit contract with the municipal enterprise. In other words, contracting with a private company may be seen too risky and expensive, especially given the deteriorated state of many buildings.

Many municipalities have begun to break up the housing management companies into smaller entities. In Cherepovets, the municipal management and maintenance functions have not been totally separated, but the city reorganized its four municipal housing management and maintenance companies. Each company has been allocated a segment of the city. Improvements in management and repair service have varied, and the companies are effectively four monopolies within a quadrant of the city. One of the companies, however, executes housing maintenance on a contractual basis with private companies. As a result, one-fifth of the city’s housing stock is maintained on a competitive basis, but the rest have experienced no efficiency gains. In Otradnyi, the single municipal enterprise was actually bankrupt, and the authorities created a trust management in January 2000. The company experienced almost immediate improvements in its financial management, and increased efficiency in day-to-day operations. The joint-stock company still operates within a monopoly environment, though, and is not only responsible for housing management and maintenance, but also for all utility services.

B. HOUSING PRIVATIZATION

A step toward encouraging the creation of HOAs would be a policy that ends the free privatization of apartments, and no longer leaves it as an open-ended option. Without an end to
the free privatization option, it will also be difficult for local governments to allocate housing for social purposes, as tenants could privatize their units at any time. As long as buildings have mixed public and private apartments, tenants will not feel obliged to assume responsibility for the whole building, as the non-privatized apartment tenants will rely on the government for repair and maintenance work. The local government would then remain responsible for the entire building, since there would be no clear division of the common building space and shell among private and public tenants. In this scenario, as is currently the case, there is virtually no incentive to form HOAs, as the financial gains to individual residents from joining is negligible. As long as such wide variations in income persist, creating effective HOAs will be difficult, as various income groups have different preferences for types of maintenance and rehabilitation services. In the absence of consensus, the chosen service levels tend to that preferred by the lowest income groups within a building.

C. Creating Household Demand

The first reform initiative—raising tariffs—serves a dual purpose of improving the financial viability of service providers, while simultaneously creating a price incentive for households to reduce consumption. However, for tariffs to affect consumption levels, household demand must be able to respond to changing tariffs. As long as norms are used, as is now common throughout Russia, households’ changes in consumption are invariant to the tariff charged. In fact, the propensity of Russian households to over-consume utility services are evident when comparing Russia’s consumption figures for heat and water with those of Western Europe. Russian households, for example, consume on average 280 liters per capita per day (lcd) of water, compared with Western Europe’s average of about 160 lcd. In addition, current cost recovery is predicated on norms that are based on production levels typically ranging from at least 300 lpcpd to over 400 lcd. While these averages hide regional variations, they are indicative of the gap between actual consumption and the norms used.

Metering actual consumption would benefit households, as the price charged for services would be based on actual consumption, rather than inflated norms. Moving away from normative pricing requires that service providers be able to meter actual consumption. Ideally, each user would have its own meter, but the nature of the Russian housing stock would make individual metering technically difficult and prohibitively expensive. A second-best solution would be to install meters in apartment blocks. Such block metering requires an ability to share out costs to individual apartments. The most efficient way to do this is to create building-level management structures, such as HOAs, that can allocate costs across tenants, thereby getting closer to charging users for actual consumption.

Housing management structures could therefore act to encourage greater efficiency in consumption among residents, and help to reduce the over-consumption prevalent in systems that use norms for allocating costs. Absent effective building-level management, residents also have limited recourse for placing pressure on enterprises to improve the quality of services delivered. Building-level management can be encouraged through mechanisms that promote some form of tenant participation, but the Subprogram is silent on this matter. Discussions of the Short Note with Government in June 2002 indicated that there was agreement on the importance of such reforms, as well as interest in moving forward on this issue.
D. Creating Building-Level Management Structures

On the household side, it has been difficult to establish the appropriate incentives for people to manage their own buildings and to encourage efficiency in the consumption of resources. In fact, in most places, not even building-level metering is available to monitor actual consumption, and apartment-level metering is too expensive, or not possible for technical reasons (as is the case with heat). Pricing for utilities, in particular heat, is therefore still based on norms. Some municipalities have begun to grapple with metering issues, and are considering how they might create the incentives for households to reduce consumption. In the case of Cherepovets, extensive investments have been made in energy-saving technologies, such as metering at the building level, and installation of exchange valves in basements and heat valves in apartments. But the lack of HOAs makes it difficult to share out costs to individual tenants, leading to an inability to price consumers for actual consumption. Consequently, households still open windows to cool down apartments, rather than adjusting the heating valves. This illustrates the importance of having functioning management structures at the building level that can create incentives to reduce consumption binding at the apartment level, even though the metering might be at the building level.

All cities visited reported a lack of citizen interest in forming associations to manage and maintain their buildings. This is in large part because local governments, through the unitary enterprises, still act like the managing unit for the buildings. The benefits from forming building-level management structures will bear the fruits of improved building conditions only when HOAs can contract services in a competitive environment, and not from monopoly unitary enterprises. Tenants must perceive that forming associations will lead to improved building maintenance and repair. Currently, households and HOAs have no alternative than to contract with the municipal enterprises. Municipal maintenance enterprises will thus have to be transformed and forced to operate in a competitive environment, which requires the breaking-up of monopoly housing management and maintenance companies.

Municipal government interest in supporting the creation of building-level management structures in which tenants participate is very important. The local administration in Dimitrovgrad is trying to encourage the creation of condominium associations, but only in buildings where over 80% of apartments have been privatized. In general, HOAs still represent less than 5% of the housing stock throughout Russia.

2. Reforming Unitary Enterprises

The lines of distinction between local governments and municipal enterprises are blurred, and the degree to which enterprises are autonomous from local authorities is not always clear. Local officials often view the enterprises as departments of the local government, and subject them to influence from local politicians. The unclear separation of enterprises from the municipal authorities also creates numerous problems for cost recovery. Financial flows between enterprises and local governments generally are not transparent, and local governments see enterprise budgets as sources of funds.
At present, the vast majority of enterprises that provide HCS in the municipalities of Russia have the legal form of municipal unitary enterprises. This classification of enterprise was created in the early post-Soviet transition period as a way to shelter certain companies, particularly those perceived as having a social function, and make them ineligible for privatization. The practice of recent years has shown that this unique legal form has a number of deficiencies that detract from the efficient management of the enterprise. These include the interference in enterprise management from local politicians, lack of transparency in operations, the inability of enterprise management to optimize the use of assets because of lack of ownership control over them, and general concerns about the quality of the management.

A. Functions of Unitary Enterprises

The Russian Civil Code defines the unitary enterprise as a commercial organization, but one upon which ownership rights over the enterprise’s assets are not conferred on the enterprise. Instead, the unitary enterprise manages these assets on behalf of the owner (the municipality) under the right of economic management. At the heart of the management problems that have been typical of unitary enterprises in the HCS sector is the contradiction between the enterprise’s function as a commercial entity providing economic services and the use of the enterprise as a vehicle for delivery of ill-targeted social protection. With the intensification of the problem of the un-funded privileges, this contradiction has become acute, and has compromised the success to date of other aspects of the reform program, such as increased cost recovery.

The housing maintenance and communal services enterprises continue to function largely in a non-market system, and under severe budget restrictions, with ambiguous allocations of roles and responsibilities. Incentives for good management are weakened by the salient legal features of unitary enterprises, including the financial relations between the enterprise and the owner-municipality as defined in the Budget Code. The incentives for enterprise management to optimize the enterprise’s use of its assets is weakened because the management knows that proceeds from the sale of unused assets, or the rental of assets, would not be retained by the enterprise. In practice, unitary enterprises have not had autonomous boards, even though they are permitted to do so. This can be contrasted with the legal form of the joint-stock company (JSC), the other common form of publicly-owned enterprise, where the ultimate owner does not exercise direct control over the enterprise, and where the board plays a central role in ensuring proper corporate governance.

B. Transforming Enterprise Management Structures

The Government’s reform program calls for municipal enterprises in the HCS sector to be converted into JSCs at the first stage of program implementation (2002-2004), with priority given to de-monopolizing the management and maintenance of the housing stock. In Otradnyi, the municipality transformed its unitary enterprise into a JSC in 2000. This JSC is one-third owned by the municipality and two-thirds by private investors. While the company still operates as a monopolist, it limits subcontracting to 10-20% of its work. While this solution is less than optimal, the main change has been a redefinition of the institutional relationship between the city and the enterprise. This has produced positive results, as the city focused on monitoring service
delivery and increasing its demands for quality on the provider, while the company focuses on improved service delivery. The fact that the JSC is still an amalgamation of utility enterprises, as well as housing management and maintenance, has not improved the city’s ability to attract investment for HCS. The JSC has produced improvements in management, but the institutional environment, particularly the relationships between enterprises and local authorities, is still in need of further reform.

The selective privatization of housing management and maintenance enterprises is expected to follow in the second stage of program implementation (2005-2010). This is an appropriate reform goal, but it is important to recognize that in view of the sheer number of enterprises involved (over 10,000 in HCS in 1999, according to Goskomstat data) and the dispersed nature of the authority over these enterprises, it is likely that the process of corporatization will take some years to complete. In the meantime, it will be important to introduce into the functioning of the municipal unitary enterprises greater transparency and good management practices as soon as possible—for example, by requiring supervisory boards and external audits.

C. PRIVATIZATION AND ENTERPRISE FINANCES

As outlined in the Subprogram, the current plan is to privatize the unitary enterprises, but this can only be done after tariffs have been raised to full cost-recovery levels. Successful privatization is seen as a means to inject credibility into the management of the enterprises, and by improving management, it offers the promise of profitable financial statements. As reform of the financial sector progresses, enterprises should be able to raise both working and investment capital on the strength of their financial statements and improved management.

Successful reform of unitary enterprises will require cleaning up companies’ finances, creating the incentives to encourage efficient operations and an ability to respond to consumer demand. A first step would be an explicit recognition of all assets and liabilities, both contingent and those on the balance sheet, as well as the appropriate write-offs for economically obsolete capital and bad debts, many of which are arrears from state enterprises. In fact, the exact nature and extent of the arrears between enterprises, suppliers and local government budgets is often not very explicit. Clearing up all arrears and making transparent the flow-of-funds between various entities will require strong political will on the part of local authorities.

D. HOUSING MAINTENANCE

Existing housing maintenance enterprises are vertically integrated. They include professions from low-skilled labor to high-skilled elevator service technicians, and providers with no capital investments to those with significant investments in machinery. These providers would not be vertically integrated in a well functioning marketplace. For example, there would be numerous plumbing firms, companies specializing in elevator maintenance, and enterprises for which capital investment was not a barrier to competition. The key to eliminating the requirement for vertical integration of housing maintenance enterprises is the introduction of property managers into the system. Property managers could efficiently manage buildings for many HOAs simultaneously, and would be in a position to bid for services in a competitive market on behalf of the owners. The establishment of a competitive market for housing management will be
conducive to the development of competitive and private markets for housing maintenance, repair and other non-network services.

From the household perspective, the current arrangement, where local authorities are expected to be responsible for all repairs and maintenance, reduces routine financial obligations, while also allowing households to avoid insuring against physical risks, such as those to roofs and elevators. Local authorities cope with the financial burden imposed by the physical housing stock by addressing only the most pressing needs. All cities reported a substantial backlog of repair and rehabilitation work on the housing stock, and some administrations are trying to address this issue by restructuring the maintenance companies. The two maintenance trusts, which historically managed the housing stock in Dimitrovgrad, have been split into public housing management companies and private maintenance companies that are contracted to do maintenance and repair works. Competitive bids are organized for maintenance. The two maintenance companies and ten other private firms were contracted competitively to do capital repair work on buildings and, as a result, the work performed increased by 20% in 2001 for the same amount of funding as was spent on capital repairs in 2000.

Some municipalities have begun limited reform with regard to housing maintenance and have started to hold competitive tenders for segments of the maintenance markets. While some improvements were experienced in maintenance services, all agreed that the gains were modest and could be greatly improved if a competitive market in maintenance could be developed. In addition, even where private contracts have been used, maintenance is still priced on a normative basis; i.e. by square meter or number of rooms. There is thus no link between the maintenance tariff and the quality and quantity of services provided. Unless such a link can be developed, the maintenance market will not deliver services to the degree that would allow significant improvements of the current housing stock. Reforming housing management and maintenance companies presents the most serious challenge to municipal governments.

E. Utility Enterprises

Great care must be taken to establish a pro-competition regulatory environment. The for-profit private joint-stock form is probably appropriate for gas and electric. In the case of water and sewer, where competition is more difficult, it may be appropriate to corporatize municipally owned utilities and, where feasible, to issue concessions to operate. Water and sewer systems are run mostly by municipalities, and in some instances by the oblast. The long-run reform agenda is to privatize water and sewer delivery. While private water and sewer companies would be beneficial, privatization should follow or accompany regulatory reform. During the regulatory reform stage, these unitary enterprises could be transformed into corporatized municipally owned enterprises, which would prepare them for ultimate privatization. Many municipalities have inherited electric and gas distribution from the divestiture of enterprise housing. This generally resulted in increasing the financial burden on the municipality without generating resources to finance service delivery or maintenance of the assets. Reforms in district heating hold tremendous potential for reaping efficiency gains.
IV. INTERGOVERNMENTAL ROLES AND RESPONSIBILITIES

All three tiers of government—Federal, Oblast, and Municipal—have some degree of responsibility for the HCS sector, even though municipal authorities directly manage the sector and implement reforms. The Federal Government’s role is primarily to provide legislative guidance, although it also affects finances, either through direct financing of the sector or through its l’goti system. The Federal Government has issued subsidy policy guidelines tied to fiscal transfers for those who comply with Federal guidelines; it has imposed regulation on the building and utility industry regarding standards; it recommends eliminating the system of arrears and cross-subsidies endemic in current government relations; and it is encouraging the restructuring and ultimately privatization of unitary enterprises.

Regional authorities work closely with municipal governments, and the greatest tension usually exists between these two tiers with regard to fiscal transfers and the implementation of HCS regulation, especially tariff setting. This section will explore these areas in further detail below, and concludes by stressing the importance for all three tiers of government to work together to continue implementing the reform initiative that has gained significant momentum over the last couple of years.

1. INTERGOVERNMENTAL FINANCE

A concern that was strongly expressed in all cities is the instability and unpredictability in inter-budgetary relations between oblast and municipalities. This relates to the amount of funding available for the housing and utility service providers, and tax sharing between oblast and municipalities being changed annually—and in extreme cases within the budget year. In the case of Cherepovets, which is a net contributor to the oblast budget, the share of taxes retained was reduced from 40% to 20%. While the city had enough money to operate, this placed it under budgetary pressure in delivering municipal services. Fortunately, the city had already raised HCS tariffs to cover full operating costs and its HCS sector did not suffer as much as it could have if tariffs were much below cost.

The housing maintenance and utility services cannot be placed on a sound fiscal footing and operated on a commercially viable basis until the system of l’goti is explicitly financed or eliminated. The Subprogram appropriately focuses on the need for addressing the explicit financing of l’goti, which is a pre-condition if private capital is to be attracted into the HCS sector, and if enterprises are to be successfully privatized or corporatized. The l’goti system contributes to arrears between local governments and enterprises, as municipalities often do not receive promised fiscal transfers. L’goti should be paid from the Federal Government to the regional authorities, who then pass the money on to the municipal governments, who are to compensate the enterprises. In reality, the funds for l’goti are not forthcoming at the Federal level; thus, ultimately, enterprises do not receive reimbursement for the exemptions they provided. The under-funding of municipal enterprises also leads to arrears between these enterprises and their input suppliers.
Solving the problem of un-funded mandates and clearing up arrears and will be a very difficult process. The entire system of arrears undermines the contractual footings on which markets function. Even if all arrears are eliminated, firms might be reluctant to write off un-collectable debts and economically obsolete capital. This means that for the foreseeable future, implicit subsidies for municipal enterprises will likely remain in place. These subsidies should be scaled back and limited to those that are explicit. Subsidies must be clearly defined and well targeted, and any system of grants to the enterprise should be established for funding publicly mandated subsidies, so as to avoid future build-up of arrears. Alternatively, subsidies should be paid up front to remove budgetary uncertainty during the year, but governments at all levels might find it hard to implement such transparency given their own struggles with intergovernmental fiscal flows.

2. **TARIFF SETTING**

Most cities throughout Russia still have a long way to go in developing sound tariff-setting and regulation procedures, which are often unclear, whether from the Regional Energy Commission (REC) or a city commission. In many of the cities visited, local authorities have begun concerted efforts at establishing sound tariff-setting and regulatory regimes. The nature of the tariff regime, however, varies widely across cities, even within the same oblast and region. It is difficult to draw broad conclusions on the exact nature of tariff-setting regimes, but it is clear that a consistent set of rules regarding setting and regulating tariffs is needed. In fact, many cities complained about the fact that they lack a clear set of rules and guidance from the Federal Government with regard to reforming their tariff regimes. In addition, tariff-setting policies need to be dynamic, especially in an economic environment where tariffs do not cover enterprise expenditures, but also need to be raised annually, at least, in order to keep pace with inflation.

A complication arises in many regions as the oblasts have an REC, while the municipalities have created commissions to establish and regulate tariffs. It is important that the lines of responsibility for setting tariffs between the REC and the municipal commissions be clearly defined, so as to avoid conflicts. In some cases, RECs have replaced city commissions in tariff-setting and regulation responsibilities, which often creates confusion for service providers. The Dimitrovgrad administration had strong disagreements with its REC recently, after the city commission disagreed with the 25% heat tariff increase proposed by the REC. The city argued that the suggested tariff increase was too high, and that 10% was more reasonable. In Otradnyi, the REC delegated the right to set tariffs to the municipality’s management company. Since the municipal government was responsible for cost recovery and the financial viability of enterprises, the administration wanted to ensure that enterprises have sufficient revenue, while consumers are charged prices that reflect the efficient cost of production. The city therefore conducted external audits of enterprises in order to determine the economically justified tariffs.

In some places, the municipalities have full authority in determining tariffs, as in Yoshkar-Ola, where tariff-setting procedures are well developed. In other regions, different enterprises have their tariffs set by different agencies, as is the case in Murmansk, where heat and water supply tariffs are regulated by the REC, with the city only determining tariffs for rent and housing stock maintenance. This is partly due to the nature of the city’s economy and its location in an
extremely cold climate, where the cost of heat and energy is high due to high transport costs. Since Federal and regional subsidies are required to help contain the cost of heat, the REC is assigned with setting the heat tariff. The experience in many cities shows that when final tariff approval rests not with the mayor, but with council deputies, the drive towards full cost recovery can be more complicated. This is the case in Smolensk, where the city council, and not the mayor, approves the tariffs recommended by the commission. In Cherepovets, the mayor plays a very active role in ensuring that tariffs reflect cost-recovery levels, and the city has, as a result, managed to raise tariffs very quickly to full cost recovery.

In many places, the tariff-setting procedure is, of course, highly politicized, making reforms difficult, and a clear set of rules from the Federal Government would help to alleviate some of the current political in-fighting found in many local authorities. Enterprises need full consistency and clarity in the setting of tariffs, and regulations need to be well established and conducive to improved enterprise management. Consistency in tariff setting will be a crucial prerequisite if private investment is to be attracted to the sector.

3. CONTINUED REFORM FOCUS

It is important for local governments to maintain the reform momentum that they have created over the last couple of years. In all the cities visited, HCS subsidies are multiples of those expended in market economies, largely due to the improper pricing of services. Yet, little is gained for these expenses, and the capital stock continues to deteriorate while subsidies remain largely unaccounted for and unmeasured. Without continuing the tariff reforms there will be little scope for reducing subsidies and improving the sector’s financial integrity.

HCS reform should be focused on areas where there is agreement that it is desirable, and where local leadership is committed to reform. All cities visited have implemented reform agendas in tariffs and improved their system of housing allowances. In other words, despite the press accounts of resistance, widespread gains are being realized, and more could be achieved if greater attention were given to introducing more demand-side pressures into the process. Greater attention should be given to introducing greater consumer responsiveness to tariff changes, through the creation of building management structures, such as HOAs. At present, none of the cities visited have managed to effectively cede building ownership or restructure municipal service companies.

All of the cities visited have begun to reform various aspects of their HCS sectors. Various aspects of reform, with varying degrees of success, have been implemented in many spheres of the HCS sector in different municipalities, although none have to date managed to fully implement the comprehensive reform package as listed in the Subprogram. Cities are sensitive to political repercussions, lack information on implementing a comprehensive reform strategy, and have a shortage of resources, both human and financial. The varying degree of reforms across cities means that municipalities can learn from each other’s experiences, and assess what is possible and how they might implement reforms locally. It is important that cities maintain the reform momentum they have established, and that the Federal Government creates an environment that supports their efforts.
REFERENCES


## ANNEX 1: PROFILE OF CITIES VISITED

<table>
<thead>
<tr>
<th>Municipality</th>
<th>Population ('000)</th>
<th>Homeowner Associations (number of buildings)</th>
<th>Cost Recovery * (% from tariff)</th>
<th>Cost Recovery (% actual from population)</th>
<th>Collection Rate</th>
<th>Burden Limit (% income)**</th>
<th>Second Basis***</th>
<th>Households Receiving Housing Allowances (% total)</th>
<th>Municipal Expenditure on HCS (% total)</th>
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<tr>
<td><strong>Volga Region</strong></td>
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<td></td>
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<td>12-15</td>
<td>27</td>
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<td>90-95</td>
<td>18</td>
<td>Partly</td>
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<td>67 (oblast)</td>
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<tr>
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<tr>
<td>Vologda</td>
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<td>60</td>
<td>45</td>
<td>100</td>
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<td>5</td>
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<td>90</td>
<td>17</td>
<td>Yes</td>
<td>18</td>
<td>25</td>
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</table>

n.a. not available  
* Cost recovery: operating costs only for housing maintenance; operation and maintenance costs for utilities, sometimes allowance for depreciation and repairs.  
** Housing allowance granted when HCS bill exceeds specified percentage of household income.  
*** Alternative criterion for determining eligibility for housing allowance based on the minimum wage and established poverty line.