Commercial Real Estate Market Development in Russia

April L. Harding

Cofinancing and Financial Advisory Services (Privatization Group)
July 1995
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Foreword

This paper looks at the evolution of the commercial real estate market in Russia in the first three years of reform. Problems in this market's development have led to a severe shortage of available space, and have proven to be a huge barrier to the creation and growth of new businesses. The local governments hold a virtual monopoly on urban commercial real estate, and they show few signs of moving towards substantial divestiture or even commercial leasing. Where development is undertaken, the governments' participation is problematic — spanning the roles of owner, regulator, and developer. Crucial conflicts of interest are endemic, and the results are that the government continues to be heavily involved even in new development. The paper includes recommendations to address these problems.

The paper focuses primarily on existing commercial real estate, though potential sources for additional space (residential, industrial, and new development), are discussed. The paper does not attempt to analyze the problems in the industrial and residential real estate markets.

This paper was prepared as part of the CFS Discussion Paper Series on privatization and private sector development in developing and transition economies. Other papers in this series have covered the legal and regulatory frameworks supporting privatization in the countries of the former Soviet Union, the privatization program in Argentina, and recently, the small-scale privatization programs of Hungary, Poland, and the Czech Republic. The purpose of the Discussion Paper Series is to disseminate current practices and the lessons learned in privatization and private sector development. As a Department that covers all the World Bank's borrowing countries, Cofinancing and Financial Advisory Services (CFS) endeavors to share with outside readers some of its cross-country experience in privatization and private sector development. We are pleased to present this review of the Russian experience with commercial real estate privatization and market development.

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Bulging kiosks—standing in front of unused or underused shops—are a visual reflection of persistent structural bottlenecks in the Russian commercial real estate market. Difficulty in obtaining premises is consistently ranked as one of the most critical barriers to opening new businesses in Russia. In contrast to the success of enterprise privatization, virtually all commercial real estate is still owned by the state. The central government has delegated the rights to these assets to local governments, rather than divesting their ownership rights.1

Decentralization of the state’s real estate assets to local governments is a common feature of initial reform policies across the transition economies of Central Europe and the republics of the former Soviet Union. However, two critical and related factors distinguish Russia from the leading reforming nations of Central Europe. First, in Russia, the local governments have a virtual monopoly on commercial real estate; and, second, local governments are not moving towards commercial leasing of premises. The negative consequences of these characteristics are clear. The previous users, contributing very little to local budgets, occupy valuable commercial space, while private sector development is blocked by unavailability of premises. The critical shortage of commercial premises is further exacerbated by the extreme difficulty of transferring residential or industrial real estate into commercial use, or initiating new development.

The paper evaluates the current commercial real estate market and identifies actions to accelerate its development.

There are two ways to get more space into the hands of new businesses: privatization of existing commercial space; and, transfer of real estate currently in other uses into commercial use. The primary focus of this analysis is privatization of existing commercial real estate. Because the government still owns approximately 95% of commercial real estate in Russia, any efforts to make more real estate available to the private sector must concentrate on privatization, through either divestiture or secure leasing to private users. Because the oblast and municipal bodies control virtually all state-owned commercial space, much of the discussion will center primarily on local governments and their role in the commercial real estate problem. However, the paper also includes a discussion of the problems associated with bringing new space into commercial use. The three potential sources of new premises for commercial use are residential space, industrial space, and new development.

Given the substantial progress in privatizing enterprises, it is somewhat surprising that so little real estate has been transferred to private hands. In mass privatization, however, the land and often buildings were omitted, a fact which undoubtedly hastened the process of enterprise privatization. In small-scale privatization, the premises were usually excluded as well. Though in the official small-scale program purchase of premises was allowed, it was not required and local implementing bodies usually chose to exclude the space from the assets transferred.2 To make matters still worse, no mechanisms were established for privatization of real estate except in conjunction with established commercial enterprises, omitting vacant or an assigned premise. The result is that less than 5% of these real assets have been transferred to private ownership.

As noted above, commercial real estate assets have been decentralized rather than divested. As a result, virtually all commercial real estate in Russia, even that which is still nominally Federally owned, is controlled by the oblast or municipal administrations. The local governments are therefore key players in the Russian commercial real estate market. Oblast and municipal governments received different types of assets. Real

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1 Local governments include oblast (regional) and municipal governments.

2 A survey of small privatized enterprises conducted by the central GKI in fall of 1993 found that premises were included in the assets privatized in 33% of the surveyed firms.
estates most often ceded to municipal ownership includes premises where more purely commercial activity was taking place, especially retail or wholesale trade, as well as catering or consumer services. In addition, the municipalities control most urban land. Oblast administrations most often received control of real estate where socially oriented activity was taking place, including most educational and medical facilities, research organizations, as well as administrative facilities for government organizations. In addition, oblast agencies typically manage most commercial space that is federally owned.

**Local Government Management** Since the local governments own almost all commercial real estate, their management practices virtually define the commercial real estate market in Russia. The most important characteristic of commercial real estate allocation is its non-commercial nature. Real estate premises, whether managed by oblast or municipal agencies, have been allocated in almost all cases to whomsoever was there previously. Further, the municipal and oblast rental regimes assure that users and lessees pay rental rates that are far below any market rates. The users pay rates that depend not on the value of the space, but more often on some concept of their “social value” or, on the user’s relationship with the head of the administration.

**Power Base** The below-market rates for commercial real estate rental creates a huge economic rent which accrues to local officials. Given the extremely low rental rates, and the small amount of space available to lessees other than the pre-existing occupants, there is pervasive excess demand. Local officials and agencies have come to rely on the right to allocate these scarce resources as an essential part of their power base. The stream of personal benefits which accrue to city officials clearly plays a large role in perpetuating the continuation of non-commercial management.

The other crucial feature of the administrative structure which accounts for local management practices is the very poor incentive structure which is the result of poorly distributed ownership and control rights; in particular, the split of certain key rights which must go together for the assets to be “marketable”.

**Fragmented Ownership Rights** The control rights over commercial real estate are widely distributed among state (primarily local) agencies. This distribution is the result of the decentralization process, combined with pre-existing rights and responsibilities to commercial space. The incentive structure resulting from the distribution of control rights is perverse. The failure to move towards commercial management of space to obtain desperately needed revenue for local budgets comes from the fact that so many agencies or officials need to be involved if real estate is to be privatized (sold or leased commercially), and that they have little reason to encourage or even cooperate with such a process. The fact that a number of agents collectively hold several of the key rights compounds the difficulty in undertaking any action.

**Split of Key Ownership Rights** In addition to a large number of agencies collectively holding the ownership of commercial space, particularly “unmarketable” splits of rights are common. For instance, frequently one local agency has the right to lease the property, while another has the right to collect rental revenue. It is equally common for sales to be completely blocked where one agency has the right to sell and the other has the right to collect all or most of the sales revenue. These divisions probably account for a good deal of the inertia prevalent in the management of commercial space in Russia.

**Attempted Solution** To address the inertia and the resulting block on private sector growth, the State Privatization Committee legislated mandatory buyout options for commercial real estate lessees. Eligibility for the buy-out was restricted to all lessees who had obtained their leases in a competitive fashion. The selling price was set extremely low (also by federal legislation). However, the federal government cannot compel these buy-outs, and the local governments have no interest in implementing them. Hence, they are not being implemented. Unintentionally, the federal mandate has stifled virtually all interest in competitive leasing procedures for commercial real estate at the local level (to avoid the subsequent mandatory “giveaway”). Perversely, this attempt to make
premises available to the new private sector, has, if anything, decreased the likelihood that local governments will move towards commercial (competitive) leasing procedures.

**TWO CONCLUSIONS**

- It is crucial to the success of reforms (which are implemented in a decentralized fashion) to identify and motivate a powerful stakeholding group.
- Given their current entrenchment, the local governments, their management practices, and their incentives must be the focus of any effort to promote the development of the commercial real estate market in Russia. The required legal changes needed to compel divestiture of these assets are highly unlikely (removal of legal protection of municipal property, abrogation of local self-government rights etc.). The required institutional changes would also be problematic since they would need to substantially strengthen the central government's capacity at the local level to implement policies opposed by local authorities. Therefore, efforts to improve this market will need to focus on promoting the development of commercial management practices for locally controlled commercial real estate.

**RECOMMENDATIONS**

**For existing commercial space:**

1) Either void the compulsory “buy-out” mandate, or provide for segmentation of affected assets. If the mandate is to stay in force, a procedure for segmenting eligible from non-eligible units should be designed and implemented. All units not designated for the “buy-out” will no longer be under the threat of loss for local governments.

2) The GKI should promote commercial management of real assets by local governments through:

   - Officially acknowledging the local governments’ claims to the remaining assets;
   - Providing assistance such as “best practice” information on efficient asset management practices and structures;
   - Concentrating local government ownership by reducing independent ownership rights held by local government agencies.

A pilot effort to segment social and commercial assets owned by localities, including efforts to move the management of the latter into an independent agency should be implemented. This should be reviewed, and standard mechanisms to promote such restructuring of management should be designed and rolled-out. The design of this program must include participation of local property administrators.

**To promote creation of new commercial space:**

1) Conversion process must be made easier:

   a) Federal guidelines for residential conversion should be developed by the Ministry of Construction to block development of extremely restrictive guidelines on the local level;

   b) The Federal Committee for the Preservation of Architectural and Historical Monuments must restrict the application of “historical monument” designation.

2) The GKI should focus substantial efforts on supporting the implementation of enterprise real estate acquisition under the Post-Voucher Privatization Program guidelines.

**To promote market development:**

1) The Ministry of Construction should develop and disseminate improved urban planning instruments (also to be done with collaboration of local authorities);

2) Resolve the title registry dispute; An action on the level of the President or Prime Minister is required to pass one of the several draft registry laws and settle the long-running conflicts among numerous agencies for control of the registration process;

3) The Federal GKI and the Ministry of Justice should collaborate to establish a ranking for some of the most common conflicts to real estate and creation of an administrative-judicial process to resolve the widespread outstanding conflicts. Underlying principles for ranking these claims should be that a larger burden of proof should be placed on government bodies over private interests, and local government ownership rights should be concentrated in the administration or property committee.
COMMERCIAL REAL ESTATE MARKET DEVELOPMENT IN RUSSIA

A. INTRODUCTION

Bulging kiosks—standing in front of unused or underused shops—are a visual reflection of persistent structural bottlenecks in the Russian commercial real estate market. Difficulty in obtaining premises is consistently ranked as one of the most critical barriers to opening new businesses in Russia. In contrast to the success of enterprise privatization, virtually all commercial real estate is still owned by the state. The central government has delegated the rights to these assets to local governments, rather than divesting their ownership rights. While this practice is quite common in the initial phases of transition, two critical and related factors distinguish Russia from the leading reforming nations of Central Europe. First, in Russia, the local governments have a virtual monopoly on commercial real estate; and, second, local governments are not moving towards commercial leasing of premises. The negative consequences of these differences are clear. The previous users, contributing very little to local budgets, occupy valuable commercial space, while private sector development is blocked by unavailability of premises. The critical shortage of commercial premises is further exacerbated by the extreme difficulty of transferring residential or industrial real estate into commercial use, or initiating new development. The goal of this analysis is to identify actions that will address these issues and remove this key barrier to reform and private sector growth in Russia.

The paper evaluates the current commercial real estate market and identifies actions to accelerate its development. There are two ways to get more space into the hands of new businesses: privatization of existing commercial space; and, transfer of real estate currently in other uses into commercial use. The primary focus of this analysis is privatization of existing commercial real estate. Because the government still owns approximately 95% of commercial real estate in Russia, any efforts to make more real estate available to the private sector must concentrate on privatization, through either divestiture or secure leasing to private users. Because the oblast and municipal bodies control virtually all state-owned commercial space, much of the discussion will center primarily on local governments and their role in the commercial real estate problem. However, the paper also includes a discussion of the problems associated with bringing new space into commercial use. The three potential sources of new premises for commercial use are residential space, industrial space, and new development.

This report does not examine the complex issues associated with land market development. Because the legal and institutional framework for land management and privatization are separate, the problems regarding buildings and premises are analytically distinct. Furthermore, in general, land use rights automatically accompany claims to buildings, so that gaining title or control to the building or premises is in fact the operational issue. This conceptual and institutional distinction between land and buildings is itself one of the barriers blocking development of the commercial real estate market.

1 Local governments include oblast (regional) and municipal governments.

2 For the purposes of this discussion, I will define commercial real estate as that which is non-residential and non-industrial.

3 This approach is based explicitly on the recognition that the fundamental problem in the real estate market is insufficient supply (as opposed to too little demand on the part of potential users). While it is undoubtedly true that buyers of commercial real estate in Russia face extremely difficult conditions for purchase as well as investment, it is also true that, even under such adverse conditions, there is large unmet demand.

4 For discussion of the profound problems in the urban land market, see: “The Housing System of the Former Soviet Union: Why Do the Soviets Need Housing Markets?”
The next section of the paper outlines the basic features of the commercial real estate market in Russia, focusing on the role of local government agencies. An analysis of the barriers to privatization and real estate market development follows. The discussion of existing commercial space is separated from the potential new sources because the institutional framework regarding its current control and potential divestiture is completely different. The analysis and policy recommendations is kept separate for the same reason. Specific suggestions to address the problems identified are put forth in the final section.

Existing Commercial Space

A wide variety of state and quasi-state organizations have claims on the existing commercial real estate. The main players are the oblast and municipal governments (the administration as well as the legislative bodies or councils), the Federal government, the Federal Committee for the Management of State Property (GKI), the oblast and municipal property committees, the local Committees for the Preservation of Architectural and Historical Monuments, and the local Housing Maintenance Organizations. The role of each of these bodies, and how they interact in practice, is discussed in this section. It should be noted that it is difficult to generalize reliably, as the local governments have a great deal of discretion in their management and regulation of real estate assets, and therefore the local real estate markets are extremely heterogeneous. Nevertheless, this section provides an important description of the most common features of the local real estate markets across Russia.

THE PLAYERS The government still owns the vast majority of commercial real estate in Russia. While privatization of enterprises has proceeded at an unprecedented pace in the past two years, real estate assets have been decentralized rather than divested. In other words, the state's ownership of real estate (buildings and land) has passed from the national government to the hands of numerous government agencies at the sub-national level. As a result, virtually all commercial real estate in Russia, even that which is still nominally Federally owned, is controlled by the oblast or municipal administrations. The local governments are therefore key players in the Russian commercial real estate market. While the local councils (previously referred to as soviets, now dumas) are the formal owners, the administration executes virtually all management functions. To transfer assets, however, approval must be obtained from the relevant council.

ASSIGNMENT In general, municipal governments were assigned different groups of assets than were oblast governments. Unfortunately, it is not possible to provide a useful description of which level of government controls a specific asset or type of asset, because the delegation process was locally implemented and highly politicized in some cities. Real estate most often ceded to municipal ownership includes premises where more purely commercial activity was taking place, especially retail or wholesale trade, as well as catering or consumer services. Oblast administrations most often received control of real estate where socially oriented activity was taking place, including most educational and medical facilities, research organizations, as well as administrative facilities for government organizations. In addition, oblast agencies typically manage most commercial space that is federally owned. These assets consist principally of office space for federal agencies and institutes. The assignment process was implemented by the oblast administrations under unclear federal guidelines, which led to wide variation in allocation and politicization of the process. For example, in Perm, a long-standing bud-
get battle between oblast and municipal authorities has led to continued oblast management of assets that were designated for municipal control by federal law.

There is additional uncertainty regarding commercial and social assets that are removed from privatizing enterprises. A building listed on the balance-sheet of a privatizing enterprise may have restaurant facilities (which should go to municipal authorities) and a medical clinic (which should go to oblast officials) — to whom should the building be handed? The original status of the enterprise, whether municipal, oblast or federal also influences the assignment. Finally, the relevant privatization committee usually has some latitude regarding the assignment. From city to city it is difficult to predict which assets will be controlled by which level of government.

**Regulatory Control.** Although it is the original owner of all the real estate assets, the federal government now holds rights which are mostly regulatory in nature. The Federal Committee for the Management of State Property (GKV) exercises most of the rights of the federal government with regard to privatization and management of real estate (buildings not land), and to a lesser degree, promulgation of property rights legislation in general. This agency is actively involved in identifying the methods of privatization for real estate, including valuation procedures, method of transfer, eligible purchasers, etc.

Widespread evidence indicates growing strength on the part of local governments in numerous areas, but this is especially true with regard to real estate. This trend is primarily motivated by two factors: ambiguous laws and decrees enacted by central authorities which allow a great deal of latitude to local authorities, and local governments’ increasing familiarity and capacity to deal with the new roles engendered in the move toward a market economy. As noted, ownership rights are vested in the local councils, which are legislative bodies. Functionally, the administrations (executive bodies) exercise the government’s rights in most cases. In particular, the head of an administration has a great deal of personal influence in the management of real estate assets.

At both the oblast and municipal level there is a property committee. This agency is formally part of the administration, but is also subordinate to the Federal Committee for Management of State Property. This agency is usually staffed by relatively progressive individuals and is a force for reform on the local level. The relevant property committee always plays a major role with regard to all aspects of property (non-residential buildings) management—allocation, rental-rate setting, maintenance etc.

Another key player is the Committee for the Preservation of Architectural and Historical Monuments. Though formally subordinate to the oblast administration, in reality this agency often plays an independent role. It has a great deal of influence over the allocation and management of any building on the register of Historical Monuments. It is not unusual for virtually every building in the city center to be on this register, which gives this Committee monopolistic influence in many urban commercial cores. In addition, a surprising number of seemingly unhistorical buildings, even outside the city center, are under the purview of this group. While the formal rights of this agency are not clear, in practice, it is often effective in preventing any sales of real estate. It frequently influences the allocation process, and participates in the rental revenue streams either on a formal or informal basis. Because its role is legally ambiguous, the main determinant of the degree of their participation appears to be the strength of the personalities involved.

The Housing Maintenance agencies also play a role in the management of commercial real estate. These organizations are responsible for the day-to-day maintenance as well as the capital renovation of residential and commercial space. While not formally holding any management power, their consent is required for leasing or sale of assets which they maintain. In addition, their proximity gives them an informational advantage which is used to their benefit. Because they are frequently the only government agency in day-to-day

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8 The Privatization Program and Law prohibit the inclusion of these assets in enterprise privatization.

9 Upon investigation, it turns out that in the 1980's, centrally allocated investment and renovation funds dried up, and that one of the only sources of such funds was intended for the purposes of preserving historical monuments. Not surprisingly, the number of such monuments multiplied during this period. Casual observation reveals numerous post-World War II buildings of dubious distinction included on the register.

10 The Post-voucher Privatization Program, passed in July 1994, formally reduces their power considerably.
contact with the units, they are able to informally influence the allocation of space and collect rents. In some cases, especially in larger cities where the city administration has insufficient capacity to manage the large number of units under its control, the Housing Maintenance agencies have taken over the city's responsibilities. This practice often gives a formal structure to the widespread practice of allocating commercial rental revenues directly to maintenance of the residential stock, which will be discussed below. The formal claim which they often hold to the real estate assets is called balance-sheet holder.

The local Bureau of Technical Inventory (BTI) is responsible for maintaining records of the physical and technical specifications of both residential and non-residential buildings. While this agency has no formal authority over building management or allocation, their monopoly over the technical information for commercial buildings gives them leverage in any transfers or registrations.

Roles The roles the above state or quasi-state organizations play are partially determined by the claims they hold. There are four categories of claimants: owner; user; balance-sheet holder; and, regulator.

Owner Although the local council (formerly Soviet, now duma) is the official owner (in Russian, sobstvennik) of commercial real estate, the rights they hold are much weaker than those usually associated with ownership in developed market economies. They have the formal right to dispose of real estate assets, via sale or lease, as well as the right to use assets as collateral or to contribute the assets to the capital of a company. The functional ownership role is exercised by the local executive body, that is, the administration.

In practice, these rights are ambiguous, and the federal government, which delegated them to local bodies, frequently infringes on them. Part of the ambiguity stems from the conflicting efforts on the part of the federal government to strengthen general ownership and property rights, while it is also trying to constrain the property rights of local governments.

An unfortunate side effect of laws passed to strengthen private property rights is an increase in the entrenchment of local government control over real estate. This is particularly true of municipal governments whose assets are held under an ownership form distinct from state property, that is, municipal property. So, while the local governments, as owners, formally have the right to sell or lease the real estate which they "own", the federal government maintains some authority to specify the sale or lease process, to determine who can receive the assets, to define the range of possible prices, and so on. This struggle to seize control over real estate assets is a key front in the much wider power struggle between central and local governments. As in other areas, growing power of sub-national governments is clearly evident.

User The users or occupants of commercial premises are another distinct interest group whose claims are usually ambiguous. The traditions and mores which evolved under seventy years of socialism insure that rights based on occupancy are very strong. In the case of commercial real estate, the pre-existing tenants are usually workers collectives from whichever enterprise used the space. In most cases, these informal use rights are being converted to lease rights. That is, local property committees are establishing lease contracts with whomever is using the space. However, even in the absence of leases, the current occupants have strong informal squatter rights. Virtually any privatization process will need to take them into account. The need to coopt the pre-existing occupiers was implicitly acknowledged in the small-scale privatization program which gave large discounts and long payment periods to insiders in the tenders and auctions associated with the program.

Balance-sheet holder Another group of claimants are based on an institution unique to the Russian real estate market, the so-called balance-sheet holder. Under the Soviet system, ownership of all assets, ex-

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11This allocation of rights stems directly from the Soviet legal structure of property being held by representative bodies (soviets) for "the people". This practice was confirmed in the Law on Property in the RSFSR (Dec. 24, 1990), art. 3.

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8 Commercial Real Estate Market Development in Russia
cept personal property, was officially vested in the state. In reality, rights to use and dispose of property were vested in organizations and individuals involved with the assets on a day-to-day basis. Some of these agents had rights and responsibilities which were recorded formally, a practice which served to assign accountability for state assets to subordinate agencies. One such "right" was that of balance-sheet holder. The balance-sheet holder, which could be a state enterprise or governmental agency, was the assigned user of non-residential real estate. It was responsible for maintaining the assets and often had daily control as well.13 Under the current system, the balance-sheet holder can be a Housing Maintenance Organization, a state enterprise, or a state institute, or a former budget organization with "social functions" that allow privileged access to resources such as premises. Of the various agents involved with management of commercial real estate, the balance-sheet holder's role is the most difficult to specify. It may be confined to maintenance responsibilities, or have virtually complete control of the assets-controlling allocation, as well as collecting and keeping some or all of the rental revenue. In the instances where leases are being established, usually the balance-sheet holder is included as something resembling a co-lesser, subordinate to the owner. Depending on the strength of the balance-sheet holder, this right can either formally or informally be expanded to very closely approximate a Western notion of ownership.14

**REGULATOR** Finally, several local government agencies have regulatory rights and responsibilities that affect the disposal and day to day management of real estate. In particular, the approval of six agencies (including the balance-sheet holder) is necessary to establish a lease to commercial premises: the city archi-
worse, no mechanisms were established for privatization of real estate except in conjunction with established commercial enterprises. Given that Soviet planning led to extremely low numbers of trade and service enterprises (relative to population) this characteristic effectively excluded large proportions of commercial and potential commercial space from privatization. The exclusion of these assets has very broad negative implications, both for the privatized enterprises, the new private sector, indeed for the economy as a whole. This paper focuses on the problems of particular import for the new private sector.

The most important characteristic of commercial real estate allocation is its non-commercial nature. Real estate premises, whether managed by oblast or municipal agencies, have been allocated in almost all cases to whomever was there previously. Further, the users and lessees pay rental rates that are far below any market rates. The users also pay rates that depend not on the value of the space, but more often on some concept of their "social value" or, on the user's relationship with the head of the administration. Even small-scale privatization, which was intended to be a relatively open and competitive process, has resulted in leasing to pre-existing occupants at very low rates. The formulas for setting the official rates are fairly simple, usually based on proximity to the center of the city and some "quality" index. Then, the norm based on the lessee's degree of social preference is factored in. For example, governmental budget agencies will pay 20% of the official municipal rental rate, restaurants will pay 50%, pharmacies and eyeglass stores will pay 30%. The calculations never result in a price anywhere near a market rate. Thus, while the municipal or oblast rental norms (or rates) may be as much as 25% of comparable privately owned or managed space (what little there is), virtually no lessees are paying the norm. The vast majority of renters are paying rather fractions of the municipal norms.

The below-market rates for commercial real estate rental creates a huge economic rent which accrues to local officials. Given the extremely low rental rates, as well as the small amount of space made available to lessees other than the pre-existing occupants, there is pervasive excess demand. Local officials and agencies have come to rely on the right to allocate these scarce resources as an essential part of their power base. A most important characteristic of local real estate management is the personal benefit to local officials associated with the control of these implicit subsidy flows (see Graph #1). Local governments use this mechanism to replace subsidies to social organizations, which previously came from central sources. In this way, social clubs, charitable organizations and the like, receive not only space for their own operations, but also receive, either formally or informally, the right to use the space for commercial activity to supplement their income. Local governments also use allocation of space, in addition to preferential rental rates, to encourage certain types of economic activity in their area, an objective they clearly see as one of their primary goals. Unfortunately, less harmful tools for city planning, such as multi-use zoning districts, designation of permitted uses, and master plans are currently absent.

17 Interviews with numerous city officials confirm the continuation of adherence to the overarching Soviet legal paradigm of "that which is not (expressly) permitted is prohibited." In virtually every discussion of privatization of empty shop premises, city officials expressed conviction that such a process was not permitted.

18 For a description of the problems associated with privatizing small enterprises without their premises, see "Small-scale Privatization in Central Europe: Lessons for Russia," by April L. Harding; for an analysis of the general macroeconomic implications associated with blocked development of real estate markets in post-socialist economies, see "The Real Estate Economy and the Structure of Housing Reforms in Socialist Economies," by Bertrand Renaud, Working Paper No. 64, of the Center of Urban Planning and Environmental Management, University of Hong Kong.

19 "Users" versus lessees: not all occupants have formal leases, although this phenomenon is becoming more rare.

20 Given the absence of a market in commercial real estate assets in Russia, it is somewhat fatuous to make comparisons to a "market" price for the property. For the very small proportion of space that was sold via small-scale privatization, as well as the space subleased via private firms, the rental prices are usually 10 to 100 times the effective municipal rental price.

21 This fact is confirmed in small business surveys. One such survey which addressed this explicitly was performed by the Working Center for Economic Reform in 1992. In 1993, Bain performed similar surveys in Yaroslavl. In 1994, IBTCI as well as the author confirmed the continuation of excess demand for space.

See "World Bank Housing Sector Paper," and "The
Figure 1 - Implicit Subsidy
to a restaurant in Yaroslavl'

Subsidy for the "Yaroslavl' Cafe"

<table>
<thead>
<tr>
<th>Monthly Rent Paid for Unit:</th>
<th>&quot;Market Rate&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>2,400,000 Rubles</td>
<td></td>
</tr>
<tr>
<td>180,000 Rubles</td>
<td>&quot;Municipal Rental Rate&quot;</td>
</tr>
<tr>
<td>64,000 Rubles</td>
<td>Actual Rent: paid by lessee of cafe (with social &quot;norm&quot; factored in)</td>
</tr>
</tbody>
</table>

Why Current Practices?

Clearly the non-commercial management practices of local governments are preventing new users from getting space to open or expand businesses. In order to determine how to promote sales or commercial leasing, we must first explain the reasons for the current practices. That is, we must ascertain why the need for additional revenue does not lead to more commercial management of real estate assets by local governments. It should be kept in mind that the unwillingness to sell these assets is the norm for transition economies where commercial real estate was delegated to local bodies. Widespread uncertainty regarding appropriate prices and future budget flows encouraged local officials to hold on to ownership in Poland and Hungary. However, local authorities in both these countries moved much more quickly to establish commercial leasing practices, which allowed new users to obtain premises. Why has this not occurred in Russia?

There are several aspects of the incentive regime faced by the local governments which discourages them from viewing the real estate assets under their control in a commercial fashion. Two features of the administrative structure in particular probably account for the bulk of the inertia so evident in local management practices: diffuse ownership and control rights; and, indifference on the part of the primary stakeholder (the local administrations).

Fragmented Ownership Rights

The current distribution of control rights over commercial real estate came about when new types of authority (revenue and transfer rights) were created and delegated, and superimposed on the pre-existing use rights from the Soviet administrative structure. Under the centrally-planned system, while the “state” nominally owned all real property, use and management rights were necessarily assigned to the agencies which were utilizing them in their daily operations. Responsibilities to maintain the assets were assigned as well, sometimes to the same agency, often not. At the beginning of
the reform program, the central government initiated a decentralization process. The process of delegation of the state's formal ownership rights for most commercial real estate to the local governments was an ad hoc process generated by numerous inconsistent and often conflicting legal acts. The administrative/"ownership" structure which resulted embodies a host of local agencies with decision-making control over real estate assets. The obvious bias towards inertia comes from the many agencies or officials that need to be involved if real estate is to be privatized (sold or leased commercially), and that they have no reason to encourage or cooperate with this process.

The poor incentives resulting from the current administrative structure can best be demonstrated with reference to a normal bundle of ownership rights that make up real property ownership in a market economy. For illustration purposes, I have divided the most critical rights into three categories: revenue, transfer and use rights (see Graph #2). The transfer (or alienation) rights consist of the right to sell or lease out the real estate. The revenue rights are simply the right to the revenue from sale or lease. The use rights are the rights to occupy and specify the type of use permissible.\(^\text{23}\)

In market economies, the market compels that certain rights stay together, so that the asset itself stays

\(^{23}\)This last right must be distinguished from the ability to regulate use by zones, which is always reserved for state bodies within certain parameters and with general (not unit or user specific) application.

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**Figure 2 - Ownership Rights Bundle**

- **Use Rights**
  - Planning Committee
  - Property Committee
  - Balance Sheet Holder
  - Enterprise/Institute (BSH)
  - Worker's Collective

- **Transfer Rights**
  - Relevant Administration
  - Maintenance Organization
  - Enterprise/Institute (BSH)
  - Property Committee
  - Committee for Architecture
  - Historical Preservation

- **Revenue Rights**
  - City Administration
  - Oblast Administration
  - Federal Government
  - Property Committee
  - Committee for Architecture
  - Historical Preservation

Note that where several organizations are listed as holding a single right, it means that all agents must cooperate for that right to be exercised.

*Distribution of sales revenue is specified in the Privatization Program of 1992.

**Distribution of rental revenue is locally determined, and varies from city to city. These are the most common recipients of rental revenue.
“marketable”. That is, an “owner” holds a certain minimum bundle of the rights which insures that he cares about the value of the asset. Commonly, this minimum bundle will contain all six of the rights contained in the ownership bundle “ball” in the graph. In some cases, these rights will be split among several owners. However, what is different from the ownership of Russian commercial premises, is that certain rights are complimentary in nature and almost always stay together. The pairing of revenue with the relevant transfer rights is particularly crucial. The right to sales revenue is always paired with the right to sell. The right to rental revenue is always paired with the right to lease out the property. Further, in the normal market bundle of ownership rights, the rights to lease out, and keep rental revenues is accompanied by the right to occupy (i.e. the “owner” has the right to occupy or lease out). If leasing out, the “owner” always has the right to specify type of use by the lessee. However, he will be discouraged from unnecessarily doing so since he bears the cost in forgone revenues, since the lessee’s value for the real estate under the restriction will go down. The crucial implication of the fragmentation of control rights to real property is its direct negative influence on incentives to effectively utilize the property. The unfortunate outcome of the current fragmentation (splitting of complementary rights) is that the assets have become essentially unmarketable. There are numerous examples of this breakdown in the control structure of Russian commercial real estate. Commonly, one “owner” has the right to lease or not lease, and another “owner” has the right to rental revenue, giving rise to a clear breakdown of incentives.*

There is yet another factor contributing to the unmarketability of commercial space in Russia, which again can be seen most easily with reference to the graph, and this is a manifestation of the collective action problem. The fact that a number of agents collectively hold several of the key rights leads to increased difficulty in undertaking any action. With regard to leasing out a commercial unit, a Bain and Company survey found in Yaroslavl that as many as seven agencies are involved in the process (and can block it). In establishing a lease for such space in general, at least three agencies must be engaged (city administration, city Property Committee, and the Maintenance Organization).

The potential for overcoming the inertia was noted in the preparatory work for the Small Business Development project implemented by Bain and Company in Yaroslavl. The information flows regarding commercial premises in the city were so poor that the Property Committee and the Housing Maintenance organizations were able to grab the rights to lease out and keep the revenue for approximately 500 units. The revenue from these activities were providing a large portion of income for their budgets (approximately 65% for the Property Committee). Clearly, when the complementary rights are rebundled, even informally, the incentives to implement commercial management are much stronger.

B. WEAK INCENTIVES OF LARGEST STAKEHOLDER

For the agencies with stronger rights (the bulk of the ownership rights, such as right to allocate etc.) apathy is replaced by opposition to privatization when they are benefiting from the current situation/allocation either informally or formally.

Although there are numerous stakeholders with control rights, as described above, the local administrations do hold the bulk of the control rights as well as formal ownership. If motivated, they are the one body who could force progress toward commercial management and increased revenue generation from commercial space. However, they have been extremely slow to mobilize such efforts. Given the acknowledged budget crises, this seems perplexing. There are several reasons for this inertia. One answer can quickly be ascertained by examining a typical municipal budget. The reason local officials don’t focus much on improving management of commercial real estate is that, to them, it is relatively insignificant. Given the current rental practices, these assets contribute at most 5% to municipal budgets. The primary positive stakeholder, and by this I mean the

*See graph for the list of rights and “owners”.

24 The owner may exercise the authority to assign to a subordinate.

25 This does not imply that all ownership rights are always bundled together, rather that certain subsets of the rights are.
one who would collect the bulk of proceeds from privatization and commercial management of real estate, unfortunately has the weakest of incentives. Numerous discussions with local administration officials indicate that they view the profits and VAT taxes as far more crucial to their operations. The perception that their budget shortfalls can more easily be addressed through efforts to increase collection of these taxes discourages them from devoting resources to improving management of their real estate assets.

The lack of motivation on the part of the local administrations is exacerbated by their monopolistic position. The fact that there are so few other sources of commercial space, and hence so few leases or sales established on a competitive basis means that there are virtually no benchmarks. So, local governments have little idea what the assets might potentially generate.

In addition, the lack of alternative sources for commercial real estate protects local administrations from competitive pressures which would encourage them to improve their management of commercial space. In Poland, by comparison, the necessity of competing with housing cooperatives (which owned a great deal of commercial space in Polish cities) clearly encouraged municipal officials to improve lease terms, as well as encouraging them to abide by the contracts once established. As the officials responded to these pressures, they were able to charge rental prices comparable to those of the housing cooperatives. This competition probably explains a large part of the rapid development of the leasing and sub-leasing market for commercial real estate in Poland.

The stream of personal benefits which accrue to city officials clearly plays a large role in perpetuating the continuation of non-commercial management. City officials personally benefit from their control of real estate allocation, in terms of both money and influence. However, an important and related dynamic is often missed. There is a strong tradition of extensive government involvement in economic activity on every level. This tradition, which pre-dates the Soviet era, leads to an expectation on the part of officials and citizens alike that the government will actively intervene in business operations and economic development. While many of the formal institutional mechanisms for this practice have been removed in the initial stages of transition, several levers remain: taxation, regulation and control of real estate. So, while it is often the case that local officials oppose divestiture or hands-off commercial leasing because it deprives them of discretion—it is due not only to personal graft, but also to a deep-seated belief that the government needs to keep such levers in their control for pursuit of social and institutional goals.

More problems

Lack of Savings Instruments Yet another factor that discourages competitive leasing as well as sales of real estate, is the absence of an inflation safe savings instrument for local governments. Under the current high-inflation environment (rates of approximately 20% per month), this inability to safely shift monetary income forward creates a strong preference for rental payments which provide a constant flow of income over an equivalent lump-sum purchase payment. In Vladivostok, the municipal administration recently attempted to implement mortgage auctions to address this problem. While the auction bids consisted of a purchase price, the payments were indexed and spread out over a five to fifteen year period to assure a steady flow of revenue to government coffers.

The lack of savings instruments, as well as widely accepted inflation index also discourages long-term leasing. The source of the disincentive is the practice of breaking down the leasing process into two parts. First there is a transfer of the “right to lease”, followed by the establishment of the lease at the administratively set prices. If the transfer is open and competitive, then there will often be a very large up-front payment. Presumably, the development of an inflation index or exemption from administrative renting norms would alleviate this problem.

Poor Credit Markets Another financial factor discouraging sales and long-term leasing is the absence of long-term finance in Russia. Since potential buyers are not able to borrow for such purchases (which require higher upfront payments), the prices they can pay are necessarily lower than they would be if such credit were available. The pledging of property to

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lessees/users are mainly state bodies and other non-commercial organizations), hence real estate contributes even less to oblast budgets.

Narrow interviews with high-level officials involved with city finances expressed the opinion that improved utilization of commercial real estate assets just wasn’t “worth the effort”.

COMMERCIAL REAL ESTATE MARKET DEVELOPMENT IN RUSSIA
secure financing of any term is still quite difficult, which also contributes to this problem. These factors combine to reduce the incentive to sell or securely lease commercial real estate, since the income from doing so is less than what buyers would be willing to pay for such secure rights in the absence of liquidity constraints.

LACK OF INFORMATION Since a very small proportion of premises have moved into private ownership the markets for these assets are extremely thin. The capacity to perform valuations of real assets is extremely low, due to absence of infrastructure (qualified appraisers, zoning techniques, title verification and registrations) and human capital. For these reasons, it is very difficult for local governments to estimate the value of real estate. A common fear expressed on the part of property management officials was that they will sell at prices that are "too low". This fear clearly predisposes them to prefer leasing, and especially short-term leasing, to avoid such losses. As noted above, the small proportion of real estate that has moved to private ownership prevents the widespread use of privately set benchmarks in prices or leasing practices.

Discussions with municipal and oblast officials in seven cities indicate that these factors all contribute to the general lack of motivation to sell or commercially lease commercial real estate in Russian cities. Throughout late 1993, however, growing budget pressures persuaded local officials to start exploring ways to raise more money from their real estate assets. In Kostroma, competitive leasing procedures were being drawn up by municipal officials. In Perm, lease rate auctions were established to dispose of commercial space. In Yaroslavl', an inventory management system was established to more efficiently allocate and manage municipal real estate. The forward motion illustrated in these initiatives often relied on external assistance. More importantly, progress in this area was given an unintended set-back which will be described below. In any event, the norm for commercial real estate management in Russia, remains non-commercial.

GKI Initiatives

In response to the slow rate of development of the commercial real estate market, with its heavy costs in dampening new business development, the State Property Committee (GKI) pursued two strategies. Initially, they focused on promoting a more effective leasing regime for locally controlled assets. The aforementioned Yaroslavl' and Perm pilots constituted the first phase of this effort. Procedures for implementing competitive auctions and standard leasing documents were promulgated with some success. In Yaroslavl', an inventory management system for tracking leased municipal property was developed and successfully implemented.

Subsequently, a more radical initiative to address this problem was included in the 1994 Privatization Program, which was passed in December 1993. Motivated by the belief that only outright divestiture would assure the occupants adequate freedom to run their businesses effectively, mandatory buy-out options for commercial real estate were legislated. Eligibility for the buy-out was restricted to all lessees who had obtained their leases in a competitive fashion. The methodology for setting the price for the buy-outs was promulgated and disseminated several months later—and was set at twice or three times the yearly rent, depending on the profile of existing enterprise. Although the buy-out is initiated by the lessees, the responsibility for implementation lies with the relevant local privatization committee. Because the majority of leases were established on a non-competitive basis, and because a substantial portion of existing commercial space was not included in the small-scale privatization program, this option is applicable to a relatively small proportion of commercial real estate premises.

29 Some Russian banks are beginning to engage in mortgage lending.
30 The Economic Development Institute of the World Bank has conducted numerous training programs to address this critical problem.
31 The latter two initiatives were assisted by AID/GKI projects to promote small business development in Yaroslavl' and Perm.
32 Because the rents are ridiculously low, the yearly rental figures constitute virtual giveaways.
33 Less than half of existing commercial space was included in the small-scale privatization program, since it only applied to units in which municipal retail trade, catering or consumer service enterprises were operating. Further, many units were excluded or "lost" during the drawing up by local officials of lists of units subject to the mandatory program.
Further, the buy-outs are not being implemented. In a sample of eight municipalities there were no buy-outs through July 1994. Many reasons were given by local officials for this failure. Initially, the legislation was unclear on timing and valuation, which allowed local authorities to avoid implementation on these grounds. In some of the more assertive localities, the legal right of GKI to force divestiture while depriving the local governments of a fair price was challenged. In Yaroslavl', the Mayor simply decreed that the legislation regarding buy-outs had no force in the city. The upshot is that the local authorities did not want to give away these valuable assets and they have not done so.

To complicate matters further, the unimplemented buy-out options have had serious negative spillovers in two areas. First, the expectation that competitively leased assets are more susceptible to expropriation by Federal mandate has stifled virtually all interest in competitive leasing procedures for commercial real estate at the local level. Local officials clearly perceive that their claims to real estate assets are much stronger if subsidized or socially oriented organizations are occupants, and if there was never an open reallocation process. The second spillover effect relates to the addition of yet another unclear property claim to the already opaque layers of claims to any real estate asset in Russia. That is, all units where some organization holds a lease, which they can claim was obtained in any vaguely competitive process, are now subject to potential cheap buy-out claims. Now, for units with such potential claims, or for buildings containing such units, any sale or long-term leasing is made even more difficult.

It is undoubtedly true that the lack of divestiture and failure to develop commercial leasing practices was and is creating a huge barrier to the growth of a commercial sector in Russia. Substantial actions to address this problem are required. Unfortunately, the steps taken have unintentionally brought about the worst of both worlds. Recommendations on how to address this situation are discussed below.

Additional Sources of Commercial Real Estate

So far the paper has focused on the problems associated with privatization and management of the existing commercial real estate. However, because central planning assigned low priority to the retail and services sectors, there is a low absolute amount of commercial space. This means that even successful widespread implementation of the existing commercial space would not alleviate the existing shortage of space for new businesses. There are other sources for commercial premises, however. In particular, the conversion of residential or industrial real estate could provide a great deal of additional space to commercial users. In addition, in the longer run, new development will need to play a role in meeting the demand for commercial premises. There are substantial problems associated with each of these sources. Each will be discussed below briefly.

Conversion of residential units Throughout the reforming ex-socialist economies, privatization of residential space has been more rapid and more successful than privatization of commercial premises. This is certainly true in Russia, where 50% of apartments have been transferred to the occupants. Therefore, in Russia, as in other transition economies, conversion of residential space can play a critical role in augmenting the space available for businesses. The importance of this reallocation process is magnified by the fact that there are a relatively high number of residential premises in urban commercial cores. Also,

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34 Municipalities include: Kostroma, Yaroslavl', Irkutsk, Perm, Vladivostok, Tver, and Novgorod and Ekaterinburg.

35 As described above, the rents are set extremely low (often less than 10% of any estimates of a "market price", multiplying this low figure twice or thrice will still yield extremely low prices. By any reasonable guess, the prices generated by this formula would be far below a market price.

36 Widespread evidence of this can be found in the notes of the Boston Consulting Group and the International Business and Technical Consultants, Incorporated from the Roll-out phase of the Small Business Development Project to promote commercial leasing.

37 For a general overview of residential privatization in Bulgaria, the Czech Republic and Poland, see Ownership and Market Reform in East-Central Europe, by Thomas Reiner, Ann Louise Strong and Janusz Szyrmer (forthcoming).


39 For an excellent analysis of the skewed patterns of development which resulted from socialist planning, see "Cities without Land Markets: Lessons of the Failed Socialist Experiment", a World Bank Discussion Paper, by Alain Bertaud and Bertrand Renaud.
since title to residential units is usually much less ambiguous, new owners have a great deal of freedom to dispose of the real estate and have very strong incentives to use the space effectively.

Although obtaining official approval to convert residential premises is extremely difficult, private owners are clearly making their apartments available without the requisite permits on a wide scale. This alleviates somewhat the severe excess demand for commercial space, especially office space. Unfortunately, numerous problems are constraining more effective use of these assets. First of all, local governments are actively engaged in constraining these practices. Illegal conversion is creating wide opposition, since the residential occupants near such converted space are often inconvenienced and there is no mechanism to address the problems of shared spaces. Local laws specifically aimed at ending this practice are becoming quite common. Further, the illegality and local opposition makes the tenancy of the informal user extremely uncertain. This is a severe burden on users who need to renovate premises, or for whom reputation is important. On the national level, it is difficult to develop a constructive approach to legalizing and controlling the process of conversion due to the overall extreme housing shortage.

INDUSTRIAL Enabling reallocation of the real estate assets tied to state-owned and private enterprises has proven to be an extremely important condition for the rapid development of the new private sector in the reforming ex-socialist economies. Manufacturing enterprises are often located in the urban core of Russian cities. Therefore, production enterprises control a great deal of real estate which could be used for commercial as well as industrial entities. Unfortunately, there are numerous barriers to divestiture or commercial leasing of these assets.

For state-owned enterprises, sale is prohibited. Commercial leasing of real estate not currently needed is problematic in several ways. State-owned enterprises face a strong disincentive to lease out space, since it decreases the probability that the assets will be included in their future privatization. Even if they are so inclined, they must obtain the official permission of GKI, and often of additional supervisory agencies. The revenue from leasing is split among these agencies, and therefore the monetary incentive for official leasing is extremely weak. In some localities, the subleasing revenue is mandatorily targeted to the budget, meaning state enterprises can keep no revenue at all from leasing out their real estate. Informal leasing by state enterprises is quite common. However, this practice rarely makes space available to the new private sector, but does enable spin-offs and the creation of subsidiaries to the old state-owned enterprises. Usually there is no formal rental arrangement, for the reasons noted above. The informality of the leasing arrangement often provides the grounds for the state-owned enterprise to intervene in the lessee’s business in myriad harmful ways.

For privatized enterprises, other barriers block availability of premises to new private users. The primary problem is related to the privatization and corporatization process of enterprises under the Russian privatization program. Under the Mass Privatization program, very few real estate assets were transferred along with the enterprise in the corporatization documents listing the assets to be included in the privatized enterprise. This has led to the peculiar situation in which the privatized enterprises almost never own the land and frequently not the buildings they are occupying. Although they enjoy continued use rights, the enterprises are not able to sell, lease, contribute as capital or pledge as collateral any of these assets. Therefore, the reallocation of unneeded space, or even the real estate of essentially bankrupt enterprises is virtually impossible. Further, the so-called social assets are mandatorily transferred to the local governments, so enterprises do not hold these premises either. There is a substantial amount of commercial space in the social assets, which unfortunately goes to strengthen the monopoly power of the local authorities over such real estate.

The State Privatization Program passed by Presidential Decree in July 1994 includes provisions to allow enterprises to purchase for a nominal price the real estate involved in their “statutory activities”, including land and buildings. There are many problems in implementing this process. And, preliminary evidence indicates that few enterprises are able to take advantage of this provision. If the enterprises were to succeed in obtaining title, then sale or commercial leasing of industrial real estate would undoubtedly contribute to improving the market for commercial real estate.

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40 Ibid., Bertaud, Renaud.
NEW DEVELOPMENT The last important source for increasing the stock of commercial real estate is development of empty or unfinished buildings and vacant land. A full characterization and analysis of the practices and problems in this area of market reform is beyond the scope of this work. However, because it is such a crucial ingredient to the development of the commercial real estate market, an overview of the current practices and a list of the most problematic features follows. As in the case of the existing commercial space, all evidence supports the conclusion that the most important barriers are on the supply side, and so, the discussion focuses on this set of problems.

LAND For all practical purposes, there is no land market in Russia. As noted above, cities control virtually all potentially commercial land. Excluding Moscow, there are not even fees associated with land allocation from the city. Land is allocated most frequently on a direct negotiated basis. Infrastructure fees are charged to the developer, but are not related to the value of the land, but rather the value of the project. It is the city that plays the key role of initiator of land development.41

While legislation has been passed that would allow land sales by local governments, current practice is confined to long-term leasing. Outside of Moscow and St. Petersburg, even long-term leasing is relatively rare. The leasing rights are allocated by municipal authorities to developers on what can best be termed “opaque” bases.

BUILDINGS Auctions of long-term leases to buildings (up to forty-nine years) have been taking place regularly in St. Petersburg and Moscow, and are slowly developing in other large cities as well.42 As with privatization of units, privatization of buildings faces many bottlenecks due to control rights being spread among numerous governmental agencies. Most often the auctions are held for unfinished or unoccupied buildings, because the absence of users or controlling agencies with pre-existing claims means that ownership is clearer, and that auction proceeds need not be as widely distributed.

Until recently, the only possible way to get use rights for land was to obtain ownership or lease-rights to the attached building. Then, automatically, use of the land was assigned to the building holder. Virtually all development to this point has taken place on the basis of this mechanism. This brings up an important feature of the Russian real estate market—the separation of buildings and the land under them into two distinct regimes, with different owners (usually government agencies), as well as different allowable property rights and tenure forms. There are large transactions costs associated with this division. It makes privatization much more difficult—since the rules regarding privatization of land differ substantially from those regarding buildings. There are separate rules also for valuation, registration, collateralization and eligible purchasers. The separate regimes for title recordation and validation also add significantly to the problems associated with new development. Ironically, the separation, in particular, the less constrained character, of the market for buildings has provided the basis for an implicit “land market”, via the purchase of buildings to acquire the attendant land rights.

In addition, local officials show several of the same attitudes with regard to land and buildings as they do for commercial units. Uncertainty of the value of the assets as well as concern for secure future revenue streams encourages them to restrict transfers to leases. Lack of capacity to administer a property tax, as well as general unfamiliarity with this potential revenue base also discourages them from outright divestiture.

The legacy of socialist planning and ownership ideology has resulted in another problematic feature of the commercial real estate privatization process—the practice of tying ownership, leasing and possessoral rights to designated use. This practice and mindset is

41 For an enlightening discussion of management practices and their implications, in particular, as they relate to residential development, see Development of the Market for New Housing in Seven Cities of the Russian Federation in 1993, by Olga Z. Kaganova of the Urban Institute, March 1995.
42 While these auctions are a good sign, it is very important to note that St. Petersburg and Moscow are not representative of developments in the rest of the country. Demand by foreign companies for office space alone puts a huge amount of pressure on these cities’ authorities to free up some space. Further, both cities have legal status as subjects of the Federation, which gives them far greater leeway in setting the rules for commercial development and management of their assets. Most succinctly, local ownership rights are stronger and clearer in these cities, therefore they are moving forward.
a primary contributor to the difficulties evidenced in all these areas (leasing of existing space, new development and industrial real estate). Under the Soviet regime, possession of assets flowed from mandatory use requirements. Violation of these restrictions was sufficient grounds for revoking their control. This concept was and still is deeply embedded in the legal framework and institutions associated with property rights and land allocation. The formal links of ownership rights to specific uses prevents the allocation of real estate to its best use, and imparts continued uncertainty to security of ownership rights.

A related practice of Russian city planning, which is a direct holdover from the Soviet period, is micro-management of the urban development process. Due to the traditions of Soviet city planning, where all aspects of a development project are laid out by the municipal authorities, institutions and practices that would allow flexibility in the projects are conspicuously absent. Because local governments lack appropriate means to regulate real estate use under broad development guidelines, such as multi-use planning districts, they continue to rely on individual restrictive covenants. The result is that buildings and vacant lots are auctioned with incredibly detailed instructions on their subsequent use. It is not uncommon for local planning officials to work out an entire development plan, leaving potential developers only the decision to invest or not. This habit of privatization with restrictive use extends to stores, vacant or occupied. Potential entrepreneurs, having identified long vacant units in attractive locations are told, on approaching city officials, that the store is a barber shop, a book store or a pharmacy, and hence, unavailable for other activities.

MOSCOW AND ST. PETERSBURG Visitors to Moscow or St. Petersburg are likely to find the foregoing description somewhat pessimistic. Therefore, it is necessary to point out the enclave character of the development of the real estate markets in these two cities. The steady influx of foreigners has led to substantial demand both for commercial and residential development. In addition, the special status of these two cities as “subjects of the Federation” confers much greater legislative and administrative freedom. Finally, much greater access to technical assistance from multi- and bilateral organizations, as well as substantial contact with Western professionals, have combined to lead to much more rapid development in these two cities. In some sense, Moscow and St. Petersburg have been able to overcome the diffuse and unclear ownership problem, often through restructuring the management structure of the real estate assets (a freedom which regular cities do not formally hold). This is clearly a step forward, since the managers treat real estate as an asset and are making strides towards more effective and profit-oriented management. Unfortunately, the monopoly held by city managers on both commercial premises and land has led to problems of its own. The city is the primary developer as well as regulator, leading directly to strong conflicts of interest including clear favoritism to “friendly” developers. The corruption endemic in the development of this market is widely perceived. Officials involved in management of the development process often move back and forth between employment in private development companies and the city government profiting substantially and openly from their close relations. Or, they may receive a portion of the output in-kind (say, an apartment) or shares in the development company.

New urban development, privatization and divestiture of industrial real estate and residential conversion are all crucial to alleviating the absolute shortage of commercial space common to reforming ex-socialist countries. In addition, the increase of premises in private hands and operating on a commercial basis will put pressure on local authorities to improve the management of their own space—both through breaking their current monopoly position as lessor of commercial space and through the creation of benchmark prices, which will provide clear indicators of foregone revenues from non-commercial allocation.

C. CONCLUSIONS

A commercial real estate market, based on private ownership or commercial leasing has been very slow to develop in Russia. This lack of progress has constituted a substantial barrier to entry and growth of new businesses. What are the lessons?


—Ibid., Butler and O’Leary.
With regard to the privatization of existing commercial space, it is crucial that the incentives of local stakeholders be aligned for successful decentralized implementation. The complex and diffuse ownership claims to commercial real estate make this task difficult. However, the relative success of enterprise privatization, provides a useful comparison. The substantial decentralization of decision-making authority and other control rights to the enterprises prior to the launching of privatization necessitated a program which motivated the enterprise insiders to push the process forward. The implementing bodies (local privatization committees) played a role which was largely pro forma—stamping corporatization documents, or, which was supported by substantial central pressure and resources (privatization voucher auctions). The early delegation of the state’s ownership rights to lower level bodies of almost all commercial real estate, also necessitated decentralized implementation for privatization of these assets. However, the mechanics of this process, set forth by the various federal laws and instructions described above, did not serve to motivate implementation.

The strongest stakeholder, the local administration, did not have incentives to divest, nor to develop commercial leasing practices. The implementing agency, the local privatization committee, itself faced mixed incentives at best, since a large portion of the staff is involved with management of commercial real estate. Further, the local privatization committees are heavily influenced by the local administration and are rarely able to take actions which they oppose. One conclusion then is that it is crucial to the success of reforms which are to be implemented in a decentralized fashion to identify and motivate a powerful stakeholding group.

Since it is not possible to give all claimants a stake in the process, central policy-makers will not only need to motivate the strongest claimant, but will also need to neutralize others. In the case of enterprise privatization, substantial efforts were made to diminish the strength of line ministries, in particular, their ability to block privatization.

The occupants of most commercial space have been, thus far, co-opted through continued subsidized access to space. This practice has frozen the majority of space in extremely ineffective use. To move forward, the claims of these groups will need, in many cases, to be abrogated.

To take this point a bit further, it is clear that more attention in general must be paid to the incentives, positive and negative, embedded in the design of reforms which must be locally implemented. The federal programs must be better grounded in an understanding of local institutions, practices and incentives, if they are to achieve their aims. This brings to light an obvious institutional weakness which is undermining reforms across the board—and this is primarily the absence of a structure or process for gathering this crucial information about the local environment for reforms.

Obtaining such information and coordinating policy is particularly important in the area of commercial real estate privatization because it is clear that the management and disposal of these assets is closely intertwined with other issues, including but not limited to budget management, intergovernmental fiscal relations, local government autonomy, and fundamental property rights reform. The relationship to this last issue should be emphasized. In the area of property relations, difficulty with building consensus at the federal level on the character and speed of reform has led to the proliferation of inconsistent legislation. The ambiguity generated by the inconsistencies has created much room for maneuver by local agencies with regard to property management and privatization. The argument most often made in support of rapid promulgation of radical legislative acts is one of political expedience and the often mentioned “window-of-opportunity”. However, the cost of the resulting ambiguity, embodied in the weakening force of law and decreasing overall effectiveness of federal legislation is much higher than commonly perceived.

With regard to privatization of real property, the ambiguity of legislation, combined with the absence of attention to implementation, effectively neutralized the reform efforts.

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46 The size of the Russian Federation requires significant decentralization implementation for most reforms.

47 The inability to roll-out the initial model of small-scale privatization (fleshed out by the IFC pilot in Nizhnii Novgorod) was the first sign that local agencies were not willing to either divest or develop hands-off market-value leasing of commercial premises.

48 This illustrates an inherent contradiction between the need for rapid generation of radical legislation and the necessity for establishing a “rule of law”, both of which are seen as prerequisites for a successful transition to a market economy.
D. Recommendations

For Existing Commercial Space
The range of possible options to address the problems in the commercial real estate market is extremely sensitive to the balance of power between the center and the localities.

1) Divestiture is best, but the prerequisites unlikely
A mandatory divestiture program would require a strong federal effort, including removal of legal protection of municipal property, and abrogation of some local self-government rights. Further, massive resources would be required for mandatory divestiture to be implemented. One option which should be considered, would be to designate a date in the future, after which local governments would no longer be able to engage in commercial activity.97 This would allow them some time to divest slowly, avoiding flooding the market and resulting low prices.98

2) Promote improved commercial management
Either void the compulsory “buy-out” mandate, or provide for segmentation of affected assets. If the mandate is to stay in force, a procedure segmenting eligible from non-eligible units should be designed and implemented. All units not designated for the “buy-out” will no longer be under the threat of loss for local governments.

Buyout Procedure For units designated for the “buy-out” procedure, the following efforts should be considered:

- The Federal GKI should bring a “test case” before the Supreme Arbitration Court demonstrating the legality of the GKI’s right to compel local governments to implement the buy-out option. An Instructive Decision should be rendered and disseminated to the lower arbitrage courts.99

- The Federal GKI and possibly the Russian Privatization Center (RPC) should devote legal resources to the defense of the legality of the buyout option in local arbitrazh courts.

- Local judicial decisions and decrees opposing this legislation must be challenged in local arbitrazh courts.

- GKI, possibly in conjunction with public interest legal organizations, should assemble legal teams to take on some “demonstration” cases for small business people who have not been allowed to buy out their premises and have pursued this right in court. Similar efforts should be made to support purchase of land by building owners.

- Positive results of the above should be widely publicized.

- Local privatization committees must be encouraged to move forward in the face of administrative opposition— incentives to include i) GKI to assign to their budget some of the revenue from the sale of objects; and, ii) GKI to work together with local committees to develop new tasks for local committee staff, which does not involve ownership of real estate, so, these people don’t fear they are divesting themselves of a job.

Local Government Action After officially acknowledging the local governments’ claims to the remaining assets, the GKI should promote commercial management of real assets by local governments through:

- Proving assistance such as “best practice” information on efficient asset management practices and structures

- Concentrating local government ownership by reducing the independent ownership rights held by local government agencies

- The legality of subleasing for all real estate should be unequivocally stated and disseminated. The Ministry of Finance needs to publish clarification that subleasing revenue from state and municip-

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97 Evidence indicates that such prohibition from commercial activity in Poland, motivated local government sales of municipal enterprises.

98 It might also serve to contain the trend of expanding commercial activity on the part of local government through their control of real estate.

99 The rendering of “instructive decisions” by the Supreme Arbitrage Court has been used in two (maybe three) other areas also pertaining to property rights and privatization legislation. This procedure was developed in response to the growing backlog of cases being reviewed by the courts related to the privatization legislation, in particular in the area of jurisdiction and implementation. The “instructive decision” provides guidance for judgments by lower courts faced with similar suits, but is not binding.
pal property is not budget revenue. GKI should disseminated clear instructions on subleasing. If lessees can freely sublease their space and keep the revenue, local authorities will have a strong incentive to charge commercial rents to obtain the real value of space themselves.

- A pilot effort to segment social and commercial assets owned by the localities, including efforts to move the management of the latter into an independent agency, should be implemented. This should be reviewed and standard mechanisms to promote restructuring of management should be designed and rolled-out. The design process of this program must include participation of local property administrators.52

**To Promote Creation of New Commercial Space**

1) **Conversion must be made easier**

**Residential**. Formulation of Federal guidelines governing conversion of residential to commercial use, will protect nearby residents without the sweeping restrictions common to locally developed regulations.

**Historical**. Decrease the number of buildings designated as *historical* monuments.53

- **Historical monuments of national significance.** The federal Committee for the Preservation of Architectural and Historical Monuments should create a list of buildings of national historical significance. A list of criteria for inclusion should be circulated to the oblast administration and local committee. Buildings that fulfill the criteria must be registered on the national list with, say, sixty days of dissemination. Spot verification should be done on buildings submitted. Any building not registered is not subsequently eligible for any regulation by the local committee, or other restrictions or requirements related to its "historic-ness".

- **Historic monuments of local significance.** The federal Committee for the Preservation of Architectural and Historical Monuments should assist in creating a list of buildings of oblast and municipal significance. Criteria for inclusion on this list must be clear, and of limited application. The recordation procedure will be the same as described above (and should be done simultaneously). The contents of this list should be public. Clear instructions on procedures to challenge restrictions applied to buildings not on the list, or which should not be on the list should be published in national papers. Potential buyers and lessees will thus restrain abuse.

- **The Federal Committee for Architectural and Historical Preservation should promulgate a standard "preservation treaty" for historic buildings.** This treaty will outline allowable restrictions and requirements for buyers or lessees of buildings or units in registered historical buildings. Other restrictions will be explicitly prohibited.

**Industrial**. Substantial efforts and resources should be devoted to support the implementation of enterprise real estate acquisition under the Post-voucher Privatization Program Guidelines.

**To Promote Market Development**

- The Ministry of Construction should develop and disseminated improved urban planning practices and instruments (to be done in collaboration with local authorities). [Note: this activity is a good candidate for technical assistance and pilot efforts.]

- Resolve the title registry dispute; An action on the level of the President or Prime Minister is required to pass one of sever draft registry laws and settle the long-running conflicts among numerous agencies for control of the registration process;

- The Federal GKI and the Ministry of Justice should collaborate to establish a ranking for some of the most common conflicts to real estate and to create an administrative-judicial tribunal process to resolve the widespread outstanding conflicts. Underlying principles for ranking these claims should be that a larger burden of proof should be placed on government bodies over private interests, and local government ownership rights should be concentrated in one body-the administration. That is, government agencies should not have their ownership rights validated, they should be transferred to the administration.52

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52 One possible vehicle for such participation is the Union of Russian Cities.

53 These two recommendations were developed in the context of the Bain Small Business Development Project, for which the author served as adviser.