

Inefficiencies in the Moscow Market for Prime Office Space and
the Role of the Local Government

by

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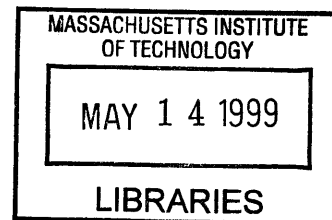
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ABSTRACT

The Moscow market for international quality office space has been expanding rapidly since the onset of the market. The growth in office stock has not been sufficient to satisfy demand for the past 7 years. Disequilibrium conditions in the Moscow office market have persisted over the typical period of a real estate cycle. With a yearly average shortfall of 200,000, the Moscow office market has sustained rents of over USD 1,000 per square meter per annum. Demand is driven by foreign firms in the trade and services sectors, looking for class-A office premises in the city center.

The purpose of this thesis is to examine the inefficiencies in the office market for quality office space in Moscow during the period of 1991 to June 1998. In doing so, the thesis focuses on the effects of the local government on new office development in Moscow.

Although there has been no shortage of eager developers looking to enjoy yields of 25 to 30 percent, the difficulty of setting up operations in Moscow, the lack of properly defined property rights on buildings and land, the inability to secure development financing and to repatriate profits, the instability of the taxation system, and the constant willingness of local officials to intervene at all stages of the development process have all undermined the development of an efficient market for quality office space.

The recent crisis in the Russian economy has reversed market conditions in the Moscow office market, resulting to an oversupply of quality office accommodations. Many international tenants are shrinking their operations in an effort to reduce operating expenses. With rents falling by 25-30 percent and with no indications for a possible economic recovery in Russia expected for the next 18 months, office construction has-at best-slowed down if not stopped. Difficulties associated with office development in Moscow, combined with weak market conditions are likely to hold back plans for new office construction for the period until June 2000. This will give the local government the time to make all necessary reforms and provide the appropriate legal, regulatory and institutional framework for an efficient office market operation in Moscow. In the presence of strong long term real estate market fundamentals and a total stock of prime office space 30 times less the office stock of London or Paris, it is only a matter of time until office demand pick ups again in the Moscow region. And this time the city must be ready.

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Introduction

In Moscow, there has been a good deal of rationalization in the office market over the past seven years of economic reform. In the beginning, there existed very little quality office space, sending prices through the roof for questionable premises. These structures often lacked one or more of the items standard in international quality offices such as parking, air conditioning, data networking and high space efficiency. Foreign companies moving into Moscow would typically set up operations in quickly remodelled apartment buildings. Today, for many companies, finding prime quality accommodations near the center is not getting easier, a situation not expected to change anytime soon.

The lack of supply has kept rents for available space high. Office rents in Moscow are usually quoted in US dollars. In the first half of the 1990s, rents often exceeded an annual per square meter rate of USD 800 for almost any type of downtown office space, simply because of the lack of supply. Only after the August crisis have tenants been able to choose locations and costs. Small firms prefer downtown locations. Suburban sites located near Moscow's ring road (Garden Ring) are attracting interest from companies that have larger space and parking requirements. Downtown buildings both new and redevelopments often have floor plates of 500 square meters and less, whereas suburban sites are more likely to have up to 1000 square meters per floor. Adding floors can be considered by managers as a communication barrier. The larger their company's space requirements the more important this seems to become.

In Moscow, the shortage of quality office premises was estimated in Spring 1998 at over 400,000 square meters. This has recently been reverted over the last 5 months, due to reduced demand resulting from the financial default. In the long term, as the local government considers economic development strategies to promote the city of Moscow as a business location, perhaps more importance should be given to the improvement in

conditions in the local real estate market. By facilitating the establishment of a competitive market for office accommodations, the cost of occupying office premises, which until today has been prohibitive for many firms interested in locating in Moscow, is likely to come down to some reasonable level, attracting further investment in the region.

Objective of the Study

The purpose of this thesis is to investigate any inefficiencies in the market for quality office premises in Moscow. It is within the scope of this study to examine the role of the local government on the development of an efficient commercial real market in Moscow. In particular, the thesis aims at assessing the impact of the Moscow City Government on the construction of new class-A office space, in the process of understanding the causes of the on-going supply/demand imbalance for international quality office premises in the city.

Methodology

The thesis begins by searching for the major sources of demand for quality office space in Moscow. We then move on to examine the characteristics of demand, supply and the market equilibrium. Later we continue by looking for sources of inefficiency first on the demand side of the market, examining the extent to which rents are representative of conditions in this market. In the course of our analysis we focus on office demand requirements by trade firms, being the representative group of tenants likely to occupy the type of space in greatest imbalance. Once we have rejected the hypothesis of inefficient signalling mechanisms causing the imbalance, we then move to look for inefficiencies in the supply side of the market. In doing so, we follow the development process from the

very early stages of planning to construction and identify problems caused by the local government, being the level of administration primarily responsible for local real estate. We also identify areas where the local government has been successful in improving conditions in the market.

Due to the importance of the legal and institutional reform in the transition process from the socialist to the free-market type economy, part of each chapter is dedicated to describing and analyzing the applicable laws and regulations. The reader however should note that due to the speed of changes taking place in the legal and regulatory regimes in the region and the lack of reliable sources of update on these issues, some of the laws presented in this paper may not be necessarily applicable at present. Also, the reader should also be cautious in using data presented in this paper on the office market in Moscow for other purposes (business plan development etc.) as the information acquired has varied greatly, depending on the source and the method used to collect it. During the course of the analysis some of these inconsistencies are pointed out explicitly. However, the reader must be aware of the fact that for the needs of the analysis, where not explicitly stated, data may have been reconciled to the writer's best knowledge.

Organization of the Paper

The thesis is organized into three major sections. Section I (Chapter 1) is dedicated to some background information, providing a general description of economic activity in the Moscow region. In Section II (Chapters 2-4), the thesis concentrates on the analysis of the office market in Moscow. Finally, in Section III (Chapters 5-9) we concentrate on the local government's role in the development process of new office space accommodation in Moscow.

Chapter 1 examines the data on major economic activities in Moscow, and identifies the main sources of demand for prime office space in the city.

In Chapter 2 we look more closely at the Moscow office market. We first examining the methods used in estimating gross office demand for quality premises in Moscow. We then analyze the basic characteristics of demand, including issues related to tenure choice of potential occupiers. Chapter 3 covers the supply side of the office market in Moscow.

In Chapter 4 we examine equilibrium conditions in the Moscow market for prime office space over the past 7 years. In doing so, we analyze the features of the office space type experiencing greatest imbalance in Moscow. In this section we also identify the local government as the part most likely to be responsible for the undersupply of new office developments.

Chapter 5 provides an overview on the assignment of responsibility and delegation of authority over issues related to the Moscow real estate among the different levels of government, as a consequence of the recent decentralization process in Moscow.

In Chapter 6 we beginning analyzing the effect of the local government on new office development in Moscow, by looking at the first stage of the development process chronologically, the planning state. The section covers all aspects of development that require licensing or permits, including the process of setting up a operations in Moscow.

Chapter 7 continues by following the development process through its second stage of land acquisition. This section describes the land market in Moscow and the process according to which the local government makes land available for new office development. This is one of the most critical steps in the overall development process in Moscow. In Chapter 8 the thesis discusses the pitfalls encountered in the process of raising development finance for new office space construction and the corresponding role of the local government. Finally, in Chapter 9 we describe how past and current

conditions in the construction market influence today's new office developments and the results of the city's efforts to promote reform in the construction sector.

The thesis ends with a small section on concluding remarks, with a short reference made to the possible effects of the recent economic crisis in Russia on the office market in Moscow.

Section I

Chapter 1

Moscow Facts: Economy, Foreign Investment and the Trade Sector

The purpose of this chapter is to examine the economic activities in Moscow in order to identify the major sources of demand for quality office premises in the capital city of Russia. The reader will be first presented with some basic information on the Moscow economy, beginning with a report on Moscow demographics. We will then continue by examining Moscow's economic transformation and the role of the city as the main destination of foreign investment in Russia. Later, we will focus on the importance of the trade sector in Moscow's economy. The section will close with a description of the city's business infrastructure, followed by the chapter's conclusions.

1.1 Demographics

The Moscow region is the largest in Russia in terms of its demographic, industrial, educational, and cultural capabilities. About 16 million people live on 41,000 square kilometers of surface representing only 0.3 percent of Russia's entire territory. There are 8.5 million people living in metropolitan Moscow¹, a population size comparable to Tokyo (8 million), Bombay (9.9 million), London (6 million), Jakarta (8.2 million), and New York (8.6 million).² This concentration of human resources has led Moscow to become a major center of financial, trade and cultural activities leaving other regions far behind.

¹ Estimate as of beginning 1996, Moscow City Committee of State Statistics.

² Fortune Magazine: The Business Life / "Where to Work" Report November 13, 1995.

1.2 Economic Transformation

With the development of market relations, priorities appeared in the Moscow region for the provision of a wide range of services missing since the socialist times. These are finance and banking activities, hotel and tourism, communications, legal, accounting, and trade services. Moscow continues to be the scientific and educational center, at the same time that its industrial significance is decreasing.³ The growing number of those employed in the above-mentioned activities of prime importance has affected all areas in city life and particularly the demand for office space.

1.3 Center of Foreign Investment

Moscow has been experiencing the largest increase in business in the whole Russian territory. Indeed, the city displays the greatest consistency among Russian cities in its market reforms, as its legislative and executive bodies are in a constant and mutual co-operation. The city not only attracts the majority of local entrepreneurs, but also hosts most foreign investment in Russia. As of July 1996, USD 3.3 billion were invested in Moscow businesses by foreigners. Only in the first six months of 1996, the flow of foreign investment into Moscow's economy constituted about 65 percent of the total volume of foreign investment inflow in Russia.⁴

Metropolitan Moscow, due to its rather comfortable entrepreneurial climate, untapped market potential and outstanding role in information and monetary turnover, enjoys the first place in preferences of foreign investors in Russia. Some 50 percent of all companies and organizations with foreign investments operate out of Moscow (Table 1.1). There are over 11,000 joint ventures and foreign companies registered in the city.

³ According to the Moscow City Committee of State Statistics the real volume of industrial production dropped in Moscow by 52 percent in the period 1992-1994. For the first half of 1996 physical volume or industrial production decreased by 22.7 percent compared to 1997 while the decrease for the whole of Russia was for the same period only 4percent.

⁴ Social-economic situation in Moscow City in January-November 1996:Statistical collection/Moscow City Committee of state Statistics-Moscow, 1996.

The majority of foreign partners come from the United States, Germany, and the UK, followed by investors from countries like Austria, Switzerland, Finland, and Turkey. Entrepreneurs from countries of Eastern Europe also aim at taking advantage of investment opportunities in Moscow through companies established in the city during the time of the Soviet regime.

Table 1.1: Number of Enterprises with Foreign Investment Registered in Moscow and in the Russian Federation in 1991 - 1996*

Region	1991	1992	1993	1994	1995	1996*
RF	2,022	3,252	7,989	13,300	20,872	22,840
Moscow	625	1,310	3,033	5,418	9,813	11,193
Growth**	109%		131%	78%	81%	28% (est.)
Percentage***	31%	40%	38%	41%	47%	49%

Source: State Statistics Committee of the Russian Federation

*First six months of 1996

**Growth in number of enterprises registered in Moscow

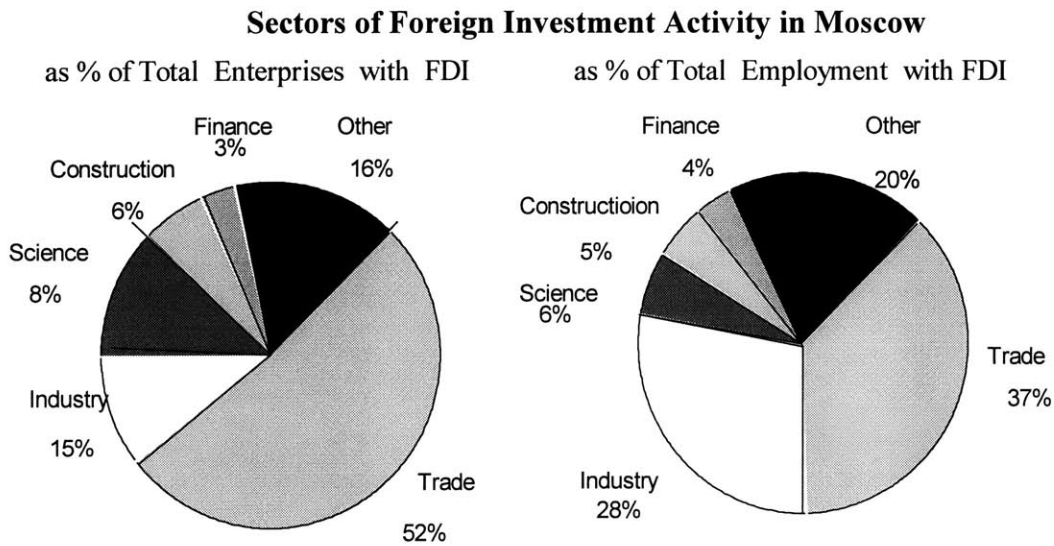
***Percentage refers to the percentage of enterprises registered in Moscow out of the number in overall Russia

1.4 Center of Trade

Large, medium, and small-scale co-operation projects are realized in Moscow. The majority of them is represented by quick cost-recovery and low capital-intensity projects with low entrepreneurial risks. A considerable part of foreign investments is channeled into newly-introduced branches of the market infrastructure: trade and public catering, hotels, credit and finance, telecommunications, information and consulting services, etc. Among these, the trade sector dominates office demand in Moscow, enjoying the highest number of operating enterprises (more than 50%), and employing over 38% of office workers likely to work out of international quality office space (see Table 1.2/Figure 1.1).

The establishment of trade companies appears to be the first step for many foreign consumer-product-manufacturers investing in Russia. First companies export products to the country, often experiencing explosive demand for their goods.⁵ Once they have reached a critical quantity of sales, these companies often find it beneficial to build their own manufacturing plant in order to avoid high import tariffs and take advantage of lower labor and distribution costs.

Figure 1.1



Source: Moscow City Committee of State Statistics

Indeed, the group that has made the greatest progress in penetrating the Russian market is the consumer product manufacturers. After seven decades of isolation, there is enormous pent-up demand for all types of consumer goods ranging from luxurious cars to chewing gum. Despite Moscow's recent demographic problems, the city offers the strongest market potential in Russia for goods and services produced by foreign investors

⁵ As shown in Figure 1.2 the majority of foreign countries investing in Moscow (primarily the OECD and European Union groups) are net exporters to the Moscow market.

abroad or domestically, with the average (official) wage of Moscow citizens exceeding the Russian average 30 percent.⁶

**Table 1.2: Main Indicators of Activity of Enterprises
with Foreign Participation in Moscow***

Economy Branches	Operating Enterprises		Employment	
	Number	As % to Total	Employees	As % Total
Trade	2,888	51.3%	40,642	37.6%
Industry	835	14.8%	29,813	27.6%
Science and Science Service	465	8.2%	6,752	6.2%
Construction	358	6.3%	5,627	5.2%
Finance and Insurance	199	3.2%	4,002	3.7%
Other	881	15.6%	21,260	19.7%
Total	5,626 enterprises		108,096 employees	

Source: Moscow City State Statistics Committee
*As of July 1st 1996

The attractiveness of the Moscow trade market to foreign investors increases once we also take into account the degree of income under-reporting. According to a market research study⁷, based on expenditures of people in the region, the average income of Moscow's 8 million residents is estimated at USD 430/month. This number signals a significant level of disposable income for Muscovites given that transport, housing and utility costs are still effectively subsidized and tax evasion is rife.

Moscow, besides its strong market potential, is the optimal place for trade of goods of "elite" consumption due to the large share of Muscovites with very high income.

⁶ Social-economic situation in Moscow City in January-December 1996: Statistical Collection/Moscow City Committee of State Statistics-Moscow, 1996.

⁷ Thornhill, John. "Russia and the CIS: Tough to Enter but Hard to Ignore." Financial Times Exporter Report, December 1996.

Wholesale purchasers prefer imported goods from Europe, the United States and Canada in view of their higher quality and a stable consumer market for them. Such trade requires some foreign participation due to the need for hard currency financing and for the credibility added by foreign investors in a market considered by western suppliers as highly risky.

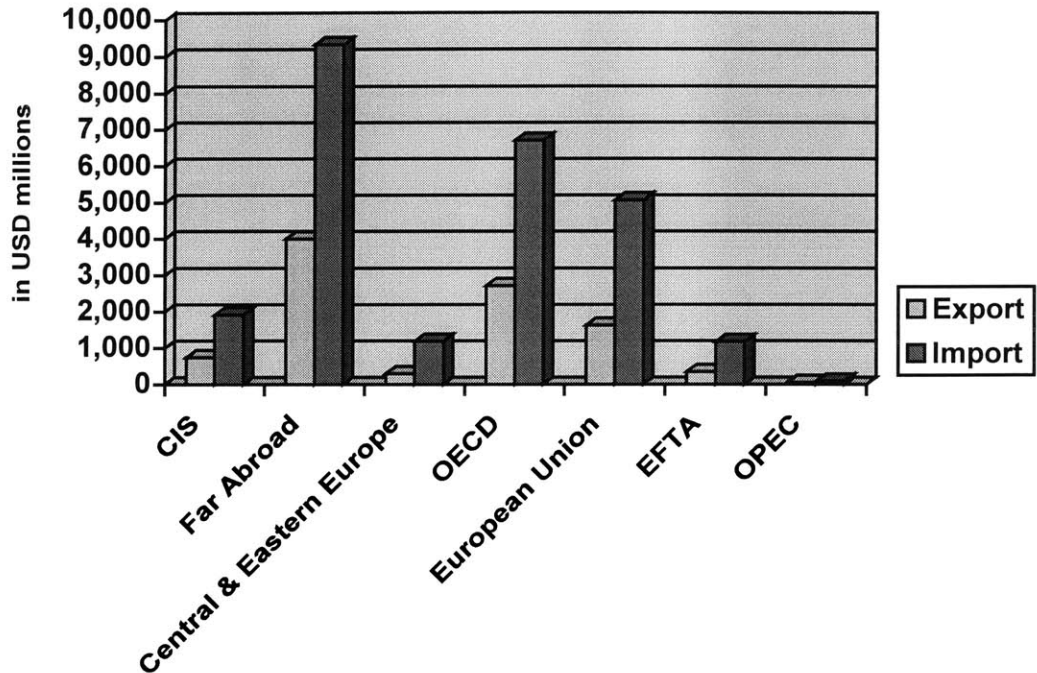
1.5 Business Infrastructure

Moscow is not only a destination market for foreign companies in the trade sector. The city is also considered (1) the most attractive location to companies carrying out import-export, agency, and other (wholesale, retail) trade operations in Russia and (2) the gateway for import and export of goods and services to other regions in Russia (Figure 1.2).

Moscow's infrastructure offers 248 customs check-points currently operating throughout the city. In terms of volume, during the first 11 months in 1996, 12 million tons of goods were cleared in Moscow. This number constitutes 40 percent of the overall physical volume of Russian imports/exports, and 60 percent of its total value. In terms of the number of commercial structures carrying out this trade activity, there is a strong concentration of trade companies in Moscow. It is interesting to note that within the first 9 months of 1996, of the 7,351 Russian firms that exported goods, 98 percent were firms registered in the Moscow region. A similar percentage (96 percent) is reported for the case of enterprises involved in importing.⁸

⁸ There are 21,648 firms located in Moscow from a total of 22,634 located in Russia. Source: Social-economic situation in Moscow City in January-December 1996: Statistical Collection/Moscow City Committee of State Statistics-Moscow, 1996.

Figure 1.2: Distribution of Imports/Exports of Moscow with Respect to Groups of Countries in 1996*



* First 9 months of 1996

Source: Customs Statistics of foreign economic activity of Moscow for 9 months of 1996: Statistical Bulletin/Moscow Customs Department – Moscow 1996.

Finally, foreign companies also view Moscow as their gateway and center of operations for conducting business in the markets of the Commonwealth of Independent States. Investing large capital in property outside Russia is considered risky due to the unstable socio-political situation and the absence of a sound legal framework.

Tapping into Moscow's expanding market may nevertheless be difficult. Moscow's tax and customs authorities can make notoriously arbitrary judgements that are difficult to appeal. Moreover, the transportation and distribution of goods can be hazardous.⁹ An opinion survey of investors showed that one of the major factors that hinder operations in Russia is that international communication lines are unreliable and underdeveloped. Corruption can also affect administrative decisions and commercial

⁹ Thornhill, John. "Russia and the CIS: Tough to Enter but Hard to Ignore." Financial Times Exporter Report, December 1996.

disputes can prove difficult to resolve in courts. Finally, foreign investors interested in expanding their operations in Moscow are often faced with a shortage of international quality office accommodations, which -when available - is offered at extraordinarily high prices.

1.6 Summary and Conclusions

In the first chapter we have identified the major source of demand for international quality office premises being foreign companies involved in trade activities. We have also presented some of the difficulties encountered by trade companies interested in locating in the city in Moscow. In the next chapters of the thesis we will focus on one of the most important problems faced by the majority of joint ventures with foreign participation in Moscow, namely the shortage and high cost of international quality office accommodations in the city.

Section II

The Moscow Market for Quality Office Space

The purpose of this section is to provide the reader with an overview on the Moscow market for prime office space. The discussion begins with a review of the demand side. The next step is to examine the stock/supply side for office premises in Moscow. Finally, we close the section with a chapter on rents and market equilibrium for quality office premises in Moscow.

Depending on their location, area, quality, functional destination, and end-user group, office premises in Moscow can be conveniently classified into three major categories, A, B, and C. Before we begin the detailed analysis of demand and supply, it is necessary that we first provide the reader with a short description of the 3 different grades of office space in Moscow:

Category A includes office premises in specialized business centers located in central districts of the city near big transport highways or subway lines. All the offices of this category are equipped in accordance with western standards. These include open floor plates of over 500 square meters, full air-conditioning, integrated telecommunications, secure power supply. Existence of good property management as well as a range of services rendered such as safety of the parking watched by guards, are mandatory requirements for this category. In most buildings it is also common to find cafeterias, copy centers and underground garages. Superior architecture and western quality building materials are usually required by most tenants. Wood paneling and glass partitioning are standard in fit-out properties. Top class office premises are usually occupied by multinational corporations, joint ventures and upcoming Russian firms, small foreign companies and subsidiaries, banks, and other institutions.

Category B offices are somewhat similar to those in category A, yet the range of additional services rendered by lessors is not so wide. Class-B space is most commonly found in refurbished properties in less premium locations. It includes buildings with smaller floor plates, often less efficient, with a 14-16 percent of space dedicated to common areas. End-users in class-B office space are likely to be institutes, administrative organizations, and small local firms. It is common to also find some international firms accommodated in class-B quality premises due to a shortage of available class-A space. This category is also preferred for back-office operations of large multinationals and local banks.

Category C includes municipal non-residential premises, basements, semi-basements, and first floors of residential buildings. Some of them are located outside the city center but at the junction of transport networks and near underground stations. The remaining class-C space is usually unfurnished office premises far from transport networks. Their advantage lies in the possibility of getting the required area of office premises at relatively cheaper prices.

From this point on in this paper any references to international quality office premises, unless explicitly stated otherwise will refer to grade-A and grade-B properties.

Chapter 2

Office Demand in Moscow

In this chapter we will first look at the different approaches used in estimating gross demand for international quality office space in Moscow. We will then examine the breakdown of demand according to the size and location of premises. Having reported on the current and anticipated future conditions in the demand side of the market, the last part of the chapter will discuss what influences the choice of tenure for the majority of prime office space occupiers in Moscow.

2.1 Estimating Gross Demand

As we saw earlier in Chapter 1, over the past five years there has been a steady increase in the number of western firms moving into or expanding their operations in the Moscow market. This has generated an increasing demand for international quality office premises. Most firms have been looking for grade-A office premises. According to real estate consultants Noble Gibbons, vacancy rates for grade-A and grade-B were 7 percent and 20 percent respectively during Spring 1998. Extended vacancies in class A premises were almost always due to asset mismanagement. At the same time, a substantial portion of the occupied Class B stock represented short-term accommodation, in anticipation of higher quality class A space coming on line. Since August 1998, vacancy rates for prime quality office premises has increased to 12 percent due to the recession.

The most commonly used approach in estimating aggregate demand for international quality office space is by means of the employment/occupancy formula.¹⁰ In the 1996 report of a major real estate consultant in Moscow¹¹, the number of expatriates

¹⁰ The employment/occupancy formula estimates office demand by multiplying the number of office employees with an average area consumed per office worker.

¹¹ Stiles & Riabokobylko/Commercial Real Estate Services. 1996 Office Market Profile: Moscow.

living and working in Moscow was estimated ranging from 25,000 to 37,000 people. According to the same source, local staff of most firms usually exceeds the expatriate staff. However even a 1:1 ratio would bring the total number of office workers likely to work out of quality office premises from 50,000 to 74,000 people. At 12 square meters of rentable space per employee, which is significantly lower than the European standards¹², aggregate demand for office space in Moscow in 1996 would support from 600,000 to almost 900,000 square meters. The same source holds that real demand is likely to be higher since this model does not account for the growing demand for international office space by Russian companies or for the increasing employment of local staff as more Russians move to managerial positions in foreign companies.

A more recent study on the demand for international quality office space in Moscow, although based on a somewhat different set of assumptions, indicates similar trends.¹³ According to the Western Group, western firms that originally started their operations in Moscow with a conservative number of expatriate staff, were adding both more expatriate professionals and local staff to their operations, inflating demand for office space. Using estimates on the number of foreigners living in Moscow ranging from 100,000 to 120,000 people, the same source calculates that 30,000 to 36,000 expatriates were in the market for international quality office space in 1997.¹⁴ Given the growing share of local employment within firms with foreign participation, the Western Group estimates that Russian staff could easily add another 300 percent to the number of people using offices, bringing the total between 120,000 and 144,000 people. According to the employment/occupancy formula and at a conservative 8 square meters of office

¹² According to the December 1996 Property Review of DTZ International, corporate users in Germany typically use a benchmark of 18-22 square meters per person, while for France (Paris) the corresponding benchmark is 18-20 square meters and for Madrid 24 square meters per person.

¹³ Aiken, Paige. "Future Predictions Still Impossible." *Estate News Moscow Supplement*, Spring 1997.

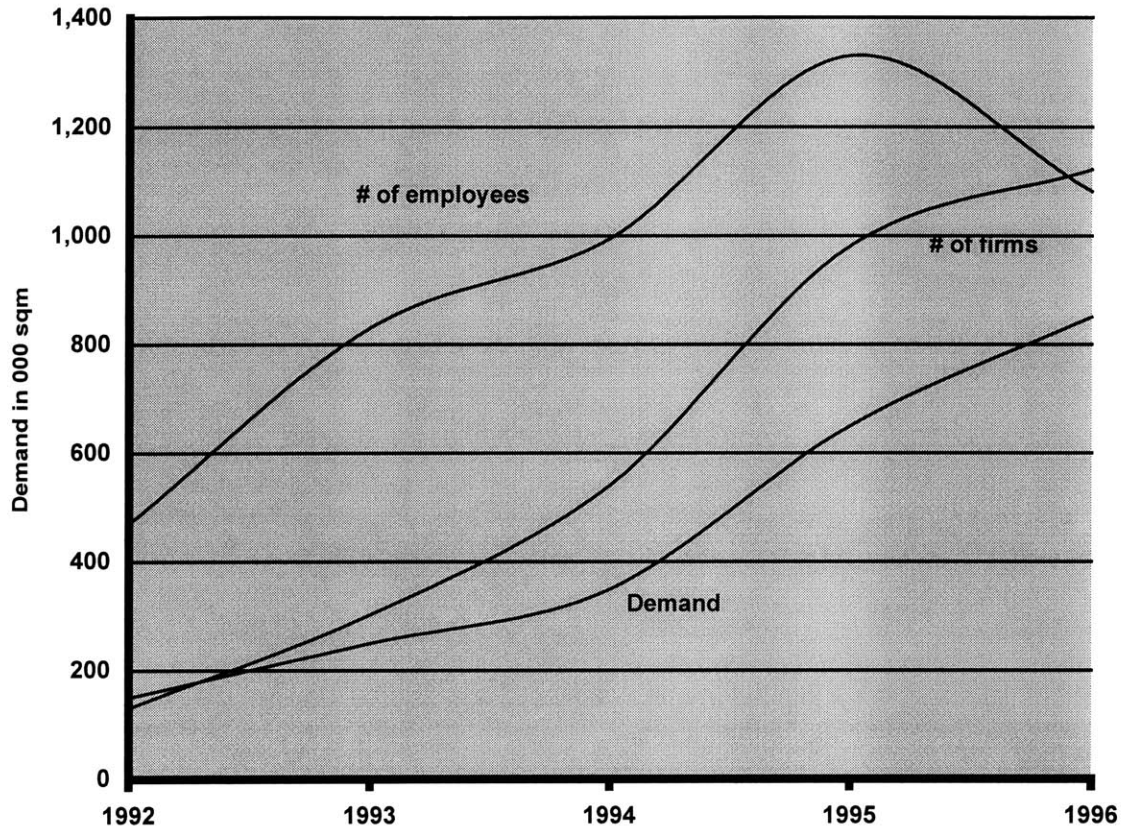
¹⁴ A conservative 30 percent of total expatriate community was assumed to be engaged in private business requiring office space.

space per person, demand for quality office space for 1997 in Moscow was estimated by the Western Group at over one million square meters.

Although the two approaches use a different set of assumptions, on (a) the contribution of Russian employees as staff in firms with foreign participation located in Moscow, and (b) space consumption per employee, it is important to note that both models base their estimates on the number of foreign employees working in Moscow. This confirms our previous assumption that most demand for quality office premises comes from firms with foreign participation. Another characteristic that the two models share is that they both fail to allow for demand fluctuations resulting from changes in rent levels. Under conditions of decreasing rents some of these firms would likely increase office space/worker to match European standards of 18-24 square meters/employee. Using a conservative estimate of 18 square meters/employee, total demand for the same number of employees could reach a level of 3.5 million square meters.

An alternative method of tracking demand, is by tracing the changes in the number of firms operating in Moscow that are likely to be located in international quality office premises. In the case of Moscow, this method is perhaps preferable, since there appears to be a stronger correlation between demand for office space and number of firms (Figure 2.1)

**Figure 2.1: Estimating Office Demand
with # of Enterprises and with # of Employees**



Source: Table 2.1

As we can see from the above graph, the number of firms with foreign participation located in Moscow is likely to be a better predictor for the direction of quality office demand in Moscow. The relationship of the number of employees working in enterprises with foreign participation and estimated gross demand for prime office space in Moscow appears to be weaker than the relationship of the number of firms and demand.

Up until the August 1998 crisis, strong market conditions had prevailed in the market. Only within two years (1992-1994) the number of firms with foreign participation locating in Moscow increased by over 300 percent. In June 1996 the number of registered firms with foreign investment in Moscow were 9 times the

corresponding number for 1992 (Table 2.1). The stronger correlation between the number of firms and office demand can be explained by the fact that some of the increase in the number of employees was driven by international companies already located in Moscow, expanding their operations. These firms would accommodate the additional personnel in the same facilities, given the difficulty of finding new space, the cost of fit-out and the long periods of prepayments required.¹⁵ Only 10 percent of class-A space absorbed in 1997 represented large Russian corporations and banks.¹⁶

Table 2.1: Growth of office demand with respect to firms and number of employees (1992-June 1996)

Year	1992	1993	1994	1995	1996
Quality office demand (in 000 sqm)	150	250	350	650	850
# of enterprises with FDI in Moscow*	1,310	3,033	5,418	9,813	11,193
# of employees**	47,000	83,000	99,500	133,000	108,000

*Source: Economy of Russia in January-June 1996. Statistical Collection. State Statistics Committee of the Russian Federation. Moscow 1996.

**Source: Social-economic situation in Moscow City in January-December 1996: Statistical Collection/Moscow City Committee of State Statistics-Moscow, 1996.

The prospects for office demand in Moscow looked promising once we take into consideration that from a total of 11,193 firms operational in mid 1996, only 183 were companies listed in Fortune's Global 500 list.¹⁷ This corresponds to a mere 37 percent of the world's largest multinationals having a presence in Europe's largest city as of 1996. Looking at the same numbers for firms listed in the Fortune's 1,000 US companies, the percentage is even lower (14 percent or 137 companies), indicating a strong market potential.¹⁸

¹⁵ These issues will be discussed in more detail in the following chapters.

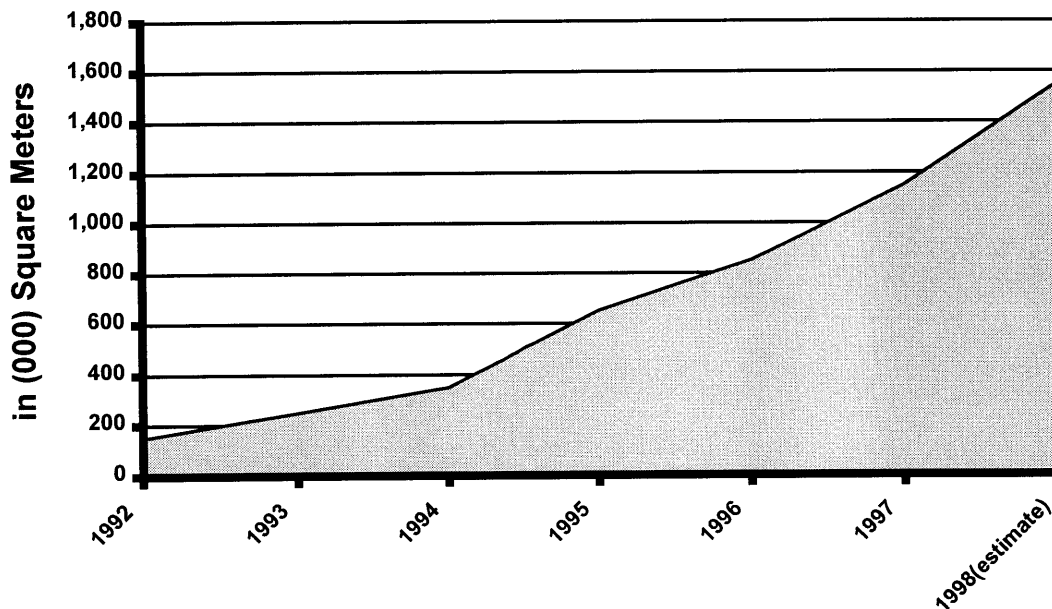
¹⁶ *Estate News*, Spring 1998 issue p. 21.

¹⁷ According to Moscow's Business Directory, Moscow's most updated and comprehensive listing.

¹⁸ The Western Group/Oncor International: 1997 Moscow Office Market Overview.

Following Yeltsin's re-election as the President of the Russian Federation in the Summer of 1996, confidence was restored among foreign investors and more companies entered the Moscow market. As the macroeconomic conditions of the country showed signs of recovery in 1997, existing companies with foreign participation in Moscow continued to expand operations and add more personnel to their payroll. This resulted in an approximately 50% increase in demand for international quality premises in only one year (1996-1997). The air of optimism continued in the market, driving 1998 demand estimates for office space to over 1.5 million square meters. (Figure 2.2)

Figure 2.2: Estimated Gross Demand* for International Quality Office Space in Moscow (class A & B)



Sources: The Western Group, DTZ, Stiles & Riabokobylko, Noble Gibbons
 *1998 figure refers to office demand estimates for year end 1998 before August 1998 crisis

All this was good news to developers until August 1998, when the financial crisis broke out, with severe consequences to foreign investors. The sectors that suffered most from the recession were the financial markets and the markets for consumer products. Banks, brokers, and other firms providing services to the financial sector are all today

trying to downsize and cut down on their overhead. Already Arthur Andersen is looking for a tenant to sublet 427 square meters of their existing space in one of the most well-known developments, Riverside Towers.¹⁹ Creditanstalt International Asset Management, Inc. is also seeking to sublet 530-1500 square meters of prime office space located in one of the most prestigious office projects, Paveletskoya Square.²⁰

The market for consumables is also going through a crisis as the ruble devaluation has significantly curtailed the purchasing power of Muscovites and all Russians. With the sector expecting a 50% decrease in sales within 1999, RJ Reynolds is already downsizing its operations in Usadba Center, where they currently occupy 3,000 square meters, looking for a tenant to sublease 710 square meters.

The only sector that perhaps could have benefited from the recent crisis is the firms involved in the production/distribution of exportable goods. A weaker ruble should normally benefit exports; the extent of the benefit would depend on how price sensitive demand is for these products. Unfortunately however, with the federal government imposing special export taxes, any potential increase in export activity has been held back, eliminating the positive effect of devaluation on the trade sector for exportables.

2.2 Breakdown of Demand

2.2.1 According to Size of Premises

According to data of the Moscow City Government, in 1996 the greatest demand (near 50 percent of total number of applications) for office space in Moscow was for small premises with a total floor space of up to 100 square meters.²¹ Only 25 percent of potential tenants would like to rent a floor space from 100 to 250 meters, another 20

¹⁹ Information on recent letting provided by the Western Group/Oncor International.

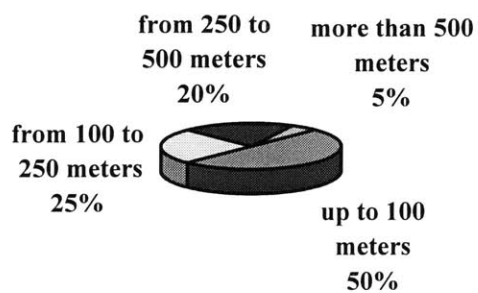
²⁰ This project was built by Turkish contractor Enka and hosts tenants such as JP Morgan, BP and Nestle.

²¹ "Welcome to the Moscow City Realty Market: Prospectus of International Conference "MIPIM 1995" – Mayor's office. Moscow 1995.

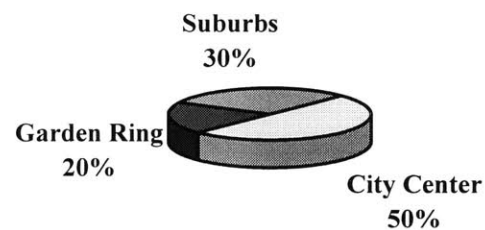
percent from 250 to 500. Very few occupiers (5 percent) are looking for premises of more than 500 square meters (Figure 2.3a). Last year (1997) saw a major expansion of international financial services with occupants such as JP Morgan leasing up 2,000 square meters, Bank of America 1,500 square meters, Deutsche Bank at 3,500 square meters, and Commerzbank at 1,500 meters.²²

Figure 2.3 Breakdown of Moscow Office Demand

(a) By Size



(b) By Location



Source: Moscow City Government

2.2.2 According to Location of Premises

Moscow is an example of a monocentric city with the Central Business District defined as the area where the Kremlin is located and with three concentric ring roads circling the city. The breakdown of demand for office space depending on location has remained stable over the past 7 years.²³ Premises in the center of Moscow are in the greatest demand (50 percent of all applications), the majority of tenants requiring an

²² Fenwick, Timothy, European Director, Jones Lang Wootton Moscow. 1998. "International Institutional Investment in Moscow Real estate: Will 1998 be the Year?". *Estate News* Spring 1998 Issue.

²³ "Welcome to the Moscow City Realty Market: Prospectus of International Conference "MIPIM 1995" – Mayor's office. Moscow 1995.

overhauled office ready to moved in. Some of the benefits identified in central office location include the availability of quality housing, proximity to ministries and other administrative organs often visited, easy access to roads and the metro etc. Another 20 percent of tenants prefer an office near the Garden Ring on the main intersections. The remaining 30 percent of demand is for office space located not far from the center or in outlying districts of the city (Figure 2.3b).

While most high profile financial groups require first class buildings in central locations in the city, IT companies which have been expanding their operations in Moscow, have been looking for less prestigious locations, in an effort to also cut down on their costs. Some of these firms were quoted in 1997 to be in the market for properties from 3,000 up to 10,000 square meters.²⁴

2.3 Future Trends in Office Demand

Acquiring accurate estimates for current demand in Moscow is almost impossible. Nobody really knows how many of the existing firms are considering relocating, closing down or downsizing. Whether estimated according to the employment/occupancy formula or on the basis of corporate growth, what appears to be a fact in today's Moscow is that the increasing trend in office demand has been severely interrupted and to a certain extent reversed.

In the near future, we should expect some 50,000 square meters of prime office space to be back in the market due to downsizing of many banks, financial institutions and firms involved in the consumer goods sector.²⁵ This comes to add to the existing 125,000 of new quality premises that have been standing empty in the Moscow city. Most foreign investors do not expect to see any signs of recovery within the next 18

²⁴Fenwick, Timothy. 1998. "International Institutional Investment in Moscow Real Estate: Will 1998 be the Year?". Article published in *Estate News* Spring 1998 issue.

²⁵ Estimate provided by the Moscow office of Jones Lang Wootton.

months. Until then, demand will most likely remain stable at the current levels with some downward trends, as more and more firms tolerate office efficiencies at 8-10 square meters per employee.²⁶

2.4 Terms of Occupancy and the Trade Sector in Moscow

Terms of occupancy play a major role in determining demand for the different types of property available. This section focuses on tenure choice of firms likely to occupy international quality office premises in Moscow. We first examine the basic criteria of tenure choice from the point of view of the majority office occupiers. We then discuss the actual priorities of trade firms interested in locating in Moscow.

2.4.1 Tenure Priorities and the Trade Sector

The first choice of location for any foreign company interested in expanding their trade operations in the region of the former Soviet Union is Moscow. The city offers multiple advantages such as: access to a relatively skilled labor force, an improving infrastructure network, the only available financial market, proximity to government administration, excellent air connections etc. During the past 7 years, new firms, whether 100 percent foreign-owned or a joint venture with local partners, have been faced with the following alternatives:

- a) purchase finished space
- b) lease space on a 3-5 year basis (with the expectation that rents will fall in the future), or
- c) purchase residential (or commercial) space at wholesale and remodel it.²⁷

²⁶ According to the Western Group.

²⁷ Particularly in the last two cases there is further opportunity to take on more space than is currently needed, leasing out the extra space to provide income in the short term. The choice of constructing their own space is a realistic option for most firms in the trade sector demand premises of up to 100 square meters, a unit size too small to justify a new development itself.

There are three major criteria affecting the choice of tenure in office market in Moscow:

- 1) Security of tenure
- 2) Cost of occupying premises
- 3) Flexibility (in choosing location and size of office premises)

Table 2.2: Office Tenure in Moscow
(as perceived by foreign companies)

Criteria	Tenure Options			Priorities of foreign trade firms in Moscow
	Option 1	Option 2	Option 3	
	Buy new space	Lease new space	Buy old and renovate	
Security of tenure*	AVERAGE	HIGH	LOW	<i>AVERAGE</i>
Cost/square meter**	4,500-7,000	750-1,000	2,500-3,500	<i>HIGH</i>
Flexibility	LOW	HIGH	LOW	<i>HIGH</i>

*During the corresponding term of occupation

**In all cases quoted prices do not include the cost of fit out. In Option 2, rents are adjusted for rental prepayments. The cost of purchasing old properties in Option 3 can be estimated at approximately USD 1,000/square meter to which about USD 2,000 should be added for construction/redevelopment costs. Source: Stiles & Riabokobylko.

2.4.2 Tenure Choice in the Moscow Office Market

Today, in most countries of the developed world, freehold ownership of property is regarded as the most secure form of tenure. However, in Moscow this is not the case. In absence of clear property rights and with the local government retaining ownership on all Moscow land including land under existing buildings²⁸, security of tenure for owner-occupied office premises is perceived as low. This is primarily due to the fact that the state reserves the right to change land-use regulations on a building even after it has been transferred to a private entity. It is only large companies that can sometimes directly

²⁸ Only with the exception of property belonging to the Russian Federation.

negotiate some of these rights with the city government up front, therefore improving somewhat their security of tenure for the agreed premises.

In 1991, when the first foreign firms appeared in the Russian trade market, a substantial share of the Moscow office market comprised of older residential properties, often well-located in the city center, but in most cases, in a state of disrepair. This space became quickly available through the housing privatization program carried out by the local government, being the owner of those properties. By the end of March 1995, the Moscow City Government had already transferred approximately 42 percent of Moscow housing into private hands.²⁹ Despite the drawbacks of refurbishment, relatively low costs (USD 1,500-2,000 per square meter of renovated space) ensured a continuous stream of old stock coming on to the market. Due to the ongoing shortage of purpose-built office space the majority of private businesses had to continue operating out of converted former housing structures.

In the meantime, a Moscow City law came into effect in 1994 banning companies from using residential space for business purposes. This had a dual effect on the real estate market for office space: (1) it increased the pressure on rents for grade A and B commercial premises as tenants were back into the market in search for new space; (2) by reverting their policies on use rights on property, it created a climate of instability with respect to the local laws and regulations governing property relations. In the eyes of foreign investors this was only an example of the city government's lack of commitment to reforms. With many foreign occupiers having lost considerable amounts of hard currency spent on residential conversion of their premises short-term leasing became the popular form of tenure. Increasing demand for rental properties replaced long-term ownership of premises with unstable use-rights attached to them.

²⁹ Economist Intelligence Unit April 1, 1995.

With the reversion of the policy allowing firms to operate out of converted former housing structures, trade firms interested in locating in Moscow were in the past 3 years faced with three basic options: either buy their own premises, purchase existing commercial space and renovate it or rent ready-to-move-in space. Trade firms, although particularly sensitive to occupancy costs, due to their vulnerability to changing market conditions and trade regimes, have often sought flexibility in the quantity of space they choose to consume. Given these considerations, rental properties, while considerably more expensive over a 10 year holding period, with total occupancy costs running at over USD 1,000 per square meter per annum, versus a USD 2,500-3,500/square meter total cost for renovated properties, and a price of USD 4,500-7,000/square meter of newly constructed properties, became the first choice of tenure among small and medium sized firms in Moscow.³⁰ With an investment horizon sometimes even shorter than the typical length of a lease (5 years³¹), most trade firms preferred to operate out of rental premises. In the meantime, some market leading multinationals involved in a handful of Russia's most strategic industries, including banking and telecommunications began in 1997 to build and own their own facilities. As of beginning 1998, nearly 10 percent of class-A stock represents these owner-occupied facilities.³²

The recent crisis in the Russia economy found tenants in rental properties the least harmed from a real estate perspective. First, they are the ones who can adjust more easily the size of their premises than owner-occupiers or tenants in built-to suite buildings. Second, they are the occupiers in the position to take advantage of the weaker markets and renegotiate their leases at 25 to 30 discount from the current levels, thus adjusting their occupancy costs. On the other hand, owner-occupied premises are not only hard to lease under weaker market conditions, but even when a tenant is found the revenue

³⁰ Stiles & Riabokobylko/Commercial Real Estate Services. 1996 Office Market Profile: Moscow.

³¹ Richard Ellis World Office Rents Report 1997.

³² Fenwick, Timothy. 1998. "International Institutional Investment in Moscow Real Estate: Will 1998 be the Year?". Article published in *Estate News* Spring 1998 Issue p.21.

collected in the form of rent by the owner is significantly reduced.³³ For these reasons, many companies occupying their own premises and have been strongly hit by the crisis prefer to write the premises off their books as quickly as possible and relocate to rental space.³⁴

2.5 Conclusions

From the above data we can conclude that demand has been increasingly stronger for class A office premises, of a size up to 100 square meters, located in the city center. The percentage of applications falling into this category approximate the percentage of trade firms (45 percent) of all joint ventures in Moscow as described in Chapter 1. This observation confirms our assumption that trade firms have dominated the demand for quality office demand (with respect to number of occupiers rather than the total size of premises demanded). Demand for quality office premises continued to be strong from the onset of the market up until August 1998. At that moment, the Russian economic crisis hit a significant portion of existing and potential future office occupiers in Moscow. With the biggest unknown being the time-frame of economic recovery, most firms with foreign participation are either relocating or subletting their space from periods from 2 to 4 years.³⁵

Given the current economic and possible future political turmoil in Russia, demand for office space has softened, while more tenants are likely to be found operating out of rental properties. Under conditions of stable demand, tenants are now able to negotiate better leases gaining as much flexibility possible built into the agreements. No significant change is anticipated in demand for quality office premises for the period of

³³ Rents will be discussed in more detail in Chapter 4.

³⁴ According to information provided by the Moscow Office of Jones Lang Wootton.

³⁵ Arthur Andersen is not subletting for a period of 1-2 years, while RJ Reynolds is even more conservative and offers space for a term of up to 4 years. Source: The Western Group/Oncor International.

the next 18 months in Moscow. The big winners in the current conditions in the market are likely to be firms working out of rental properties while the companies most harmed from the downside of the market, are companies who have built their own premises and are now finding it difficult to sublet their space even at significantly lower rents.

Chapter 3

Supply of Office Space in Moscow

3.1 The Legacy from the Soviet Regime

In the former Central and East European countries experiencing economies-in-transition, centralization of authority has had a profound impact on the structure of their real estate markets. In this region, during most of the 20th century, the state has traditionally functioned as both, the consumer and producer for most goods and services. State control over land, one of the most significant inputs of production, has historically prohibited the development of any form of land markets in the area. This is particularly true in the former Soviet Union, where the seizure of land by the state and the absence of land ownership rights goes back to the 1910s, formulating the backbone of the socialist ideology.

In the framework of the socialist ideology, construction of immovable property was considered an unproductive -thus undesirable- capital investment, unlike investments in the production of exportable goods such as machinery, oil products, agricultural goods, etc. Exportables were valuable to the Soviet state as most of the times they were exchanged with goods from other CMEA³⁶ countries, or they were shipped to the west in exchange for hard currency. Under a barter trade regime, office space had no exchange value to the Soviet economy. In most of the countries in the region, the system of command economy has resulted in an unusual mix of office stock, with respect to size, location and quality of premises. It is therefore not surprising that the stock of office space Russia has inherited from its precedent Soviet State is of very low quality compared to western standards. In fact, the majority of these previously-constructed

³⁶ Centralized Market Economies Association

office buildings, today would be considered obsolete in most countries of the developed world.

3.2 Stock Estimates for Quality Office Premises in Moscow

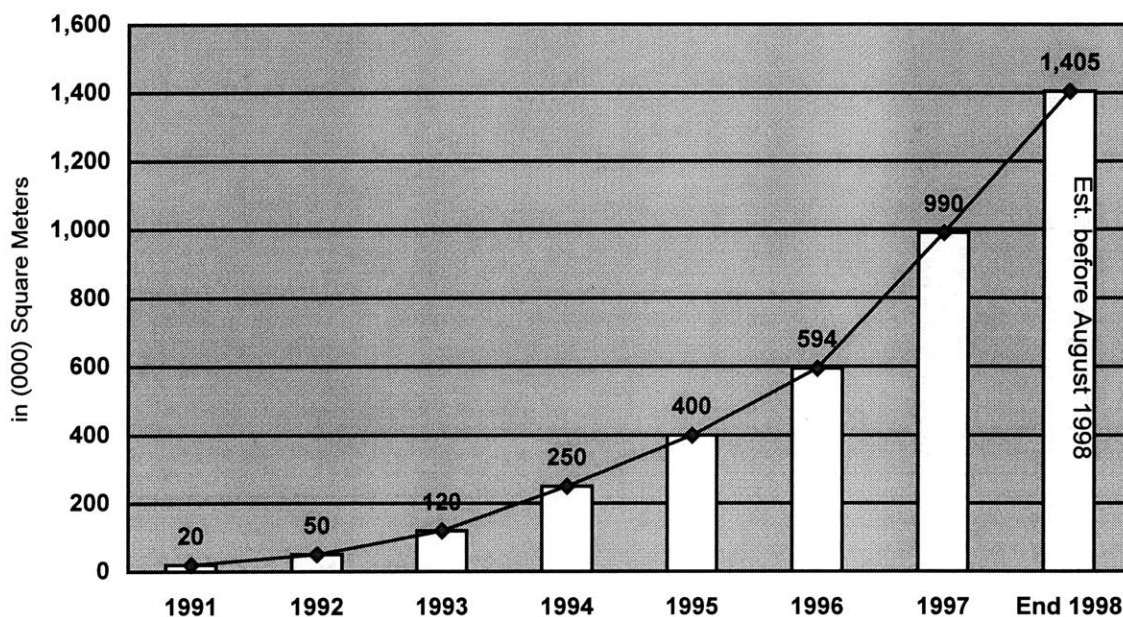
Acquiring reliable information on the actual stock of international quality office premises in Moscow is as difficult -if not more difficult- as estimating the office demand. This is primarily due to a weak property registration system, the lack of historic data on a market with only 7 years of life period, as well as to the subjectiveness in the criteria used by western professionals when classifying and reclassifying commercial premises in Moscow.

According to the data collected from 5 different sources of information and reconciled thereafter, the first year of economic transformation found Moscow with a stock of only 20,000 square meters of international quality office space (Figure 3.1) Four years later, in 1995, the stock of quality premises was 20 times more than the total space available in 1991. By the end of 1997 total stock of class A and B office premises in Moscow was estimated at approximately 1 million square meters. However, Moscow's prime office stock is still extremely limited compared to Paris or London, two of the most populated cities in Europe. Paris with a population size of 2.1 million hosts accommodates over 30 million square meters of prime office space. In London, the corresponding number is approximately 23 million. Prague, a city with a population size of not more than 1.2 million enjoys a total stock of office premises of international quality near the level of Moscow's stock.³⁷ Although population size is not a good measure for estimating economic activity and office demand, it signals however that there is clearly a very strong long-term potential for new office development in Moscow. Taking into account that there is current a stock of 10 million square meters of obsolete

³⁷ Data on office stock are drawn from Jones Lang Wootton's *1997 European Property Investment Report*.

office space of the soviet type in a country that is only now beginning to experience market economy, it is only a matter of time for office stock to reach international quantity levels in the Russian capital.

Figure 3.1 Stock of Quality Office Space in Moscow



Source: The Western Group, DTZ, Richard Ellis, Stiles & Riabokobylko, Moscow City Government

3.3 Breakdown of Office Stock

3.3.1 According to Size of Premises³⁸

Stock of quality office premises in Moscow is divided according to size of unit as follows³⁹: the most common size of office premises in Moscow is from 100 to 250 square meters (35 percent). Units of 500 square meters or more account for 30 percent of the current office stock (Figure 3.2a). Premises from 250 to 500 square meters make up for

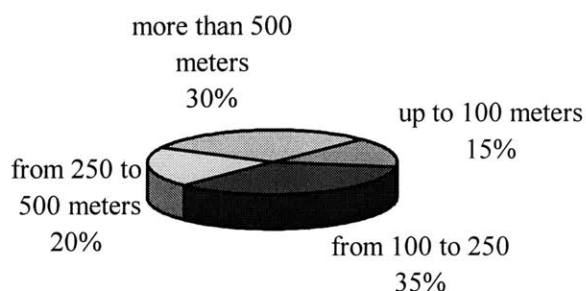
³⁸ Data on the breakdown of office stock are provided for the year 1996. The relevant information has been provided by the Moscow City Government.

³⁹ "Welcome to the Moscow City Realty Market: Prospectus of International Conference "MIPIM 1995" – Mayor's office. Moscow 1995.

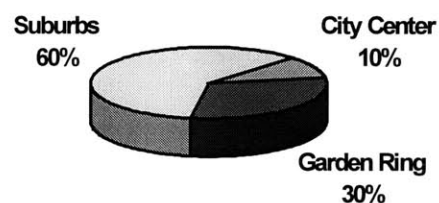
20 percent of the market. The least available premises presently are those with a surface area of up to 100 square meters (15 percent).

Figure 3.2: Breakdown of Prime Office Stock in Moscow

(a) By Size



(b) By Location



Source: the Moscow City Government

3.3.2 According to Location of Premises

In terms of location of premises, only 10 percent of office premises can be found today in the city center (Figure 3.2b). Offices located not far from the city center are about 30% of the total stock. Most of the existing office space (60 percent) is situated in outlying districts of the city.⁴⁰

⁴⁰ “Welcome to the Moscow City Realty Market: Prospectus of International Conference “MIPIM 1995” – Mayor’s office. Moscow 1995.

3.4 Supply of International Quality Office in Moscow

3.4.1 History of International Quality Office Development in Moscow

Development in Moscow first began in conditions of complete lack of premises that could meet occupier requirements. As demand increased and rents grew at a far higher rate than the prime cost of construction, profits generated from the first projects completed were very high - hundreds of per cent a year. Lessees appeared immediately, and in conditions of very strong demand, they agreed to pay any price set by the owners of the buildings. In some cases projects recouped construction costs after receipt of the very first rent payment.

The situation gradually changed. First, the prime cost of construction increased considerably. Second, as supply on the market grew, rents stopped climbing at the previous rates. Despite this, compared to Europe and the United States, office development in Moscow remained a highly profitable business, offering yields as high as 25% on capital invested in the form of hard currency. For the 4th quarter of 1997, prime yields in the European office markets were reported at 17-22 percent for Moscow, 6.25-6.75 percent for Paris, 10.5 percent for Lisbon, and 9 to 12 percent for Warsaw and Prague, being the cities seeing the second highest yield levels in Europe after Moscow.⁴¹

3.4.2 Supply of International Quality Office Space Since 1996

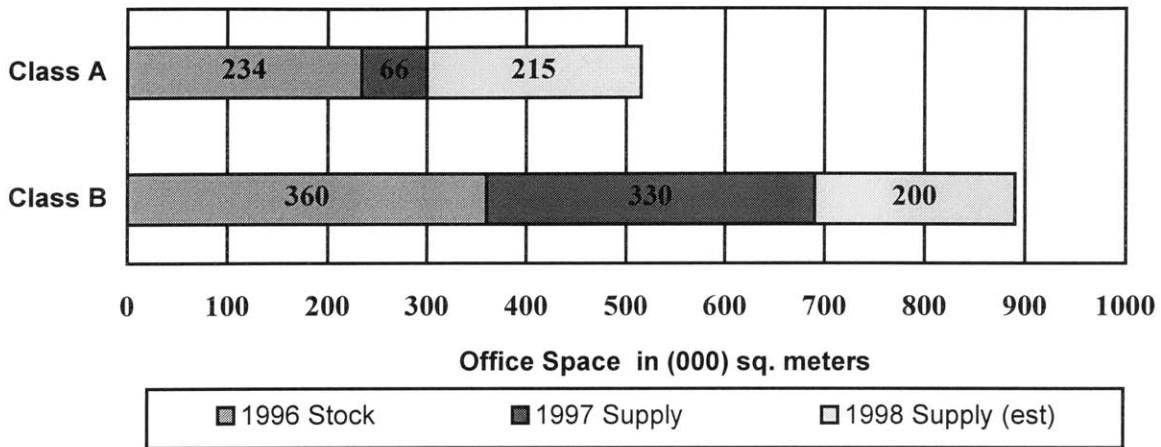
Every year over 200,000 square meters of prime office space are being commercialized at yearly rents as high as USD 1,100 per square meter. Taking into account the projects currently underway, total stock of international quality office space was originally expected to exceed the figure of 1.4 million square meters by the end of 1998.

⁴¹ Source: Jones Lang Wootton, Healey & Baker, Arthur Andersen, *EuroProperty News* February 1998 Issue.

The first developments came off the ground by companies usually in some combined form of a local and an international component. The local component often involved the local government, directly or indirectly, an example of which is Mosenka. Mosenka was one of the first developers to construct quality office space in Moscow which housed some of the first large multinationals to enter the Russian market including L'Oreal, Procter & Gamble, Clifford Chance and Salomon Brothers. Mosenka bridged Turkish capital, the Moscow City Government and the largest Turkish contractor, Enka, and developed some of the first major office buildings in Moscow (see Appendix). Some other major developments were brought to the market by foreign construction companies themselves, since they were the ones that had enough equity to bring them to completion.

However, as many of the developments initiated by local developers came to a halt as equity dried out, sometimes in the construction phase (Zenith Center), other times even in the planning stage (Olympic Plaza), the market started experiencing a separation in development capital. On one hand, foreign developers and contractors had become familiar with the Moscow market's risks and opportunities, on the other hand, new local developers appeared in the market possessing access to adequate capital. While the Moscow government continued to support new developments in view of the city's 850th anniversary celebration, in 1997, Moscow's highest quality office developments found themselves in the position of being oversubscribed two times.

Figure 3.3: Supply of Quality Office Space in Moscow



Source: Noble Gibbons in association with Richard Ellis (corresponds to estimates before 1998 crisis)

Only 66,000 square meters of class A space was delivered in 1997, establishing a total type space of approximately 300,000 square meters in the city (Figure 3.3). Most of this space was developed by foreign joint ventures (German S+T being the most famous one) or foreign contractors like Enka that had until then been hired by the local government or other local/foreign joint ventures. Consequently, class B supply took up the slack from the undersupply of class A space. Nearly 330,000 square meters of class B space was delivered in 1997, bringing the total of this type to approximately 690,000 square meters. Much of the supply of grade-B premises was driven by local developers that could gain easier access to rights on existing buildings suitable for refurbishment.

3.5 Future Trends in New Office Supply in Moscow

Prior to the crisis, approximately 415,000 square meters of international quality new office space (class A and B) were expected to appear on the Moscow market by the end of the first quarter of 1999.⁴² Over 50% of the new space was planned as type A space, the quality in highest demand. In this latest development phase a new class of

⁴² Kelleher, Jack of Noble Gibbons in association with Richard Ellis. "Still a Significant Undersupply of International Quality" article published in *Estate News Moscow Supplement* Spring 1998 Issue, p.6.

developers appeared: those were large multinationals that engaged in construction of owner-occupied premises with a speculative spin attached to them. However, the developer's market euphoria was soon interrupted by the August 1998 crisis.

The recent crisis in Russia's credibility in its finances caused as we saw earlier a major drop in demand for new office space. The segment that has suffered most from the shock is class B premises, as many tenants now take advantage of the weak market conditions and relocate to empty standing class A premises at favorable lease terms. Construction of projects already under way has at best slowed down. In some cases, projects have been abandoned indefinitely. According to recent estimates, the resulting stock of international quality office premises in Moscow at year end 1998 should not exceed 1.2 million square meters.⁴³ Many of the developments expected to come on to the market within 1998 are likely to do so well into 1999 or 2000 as the speed of construction has adjusted to the changing market conditions. Plans for major new developments are all frozen and will remain frozen for a period of at least 18 months.

⁴³ December 1998 estimates of the Moscow Office of Jones Lang Wootton.

Chapter 4

Market Equilibrium and the Moscow Market for Quality Office Premises

In the two previous chapters we discussed the basic characteristics and trends in quality office demand and supply in Moscow. Chapter 4 will be concerned with equilibrium conditions in the office market and with the factors determining the process of reaching equilibrium in the Moscow market for prime office space. The chapter begins with a quick reference to the stock/flow model of the real estate market equilibrium. We then apply the model to the case of Moscow office market. In doing so we compare demand and stock for different types of premises, identifying the main areas of demand/supply imbalance in the office market. We then continue by examining the factors affecting occupancy costs in the Moscow office market. In trying to understand the reasons for the demand/supply imbalance for prime office space in Moscow we first examine the role of rents as a market signaling mechanism. At the end of the chapter the reader is presented with the office market section's conclusions.

4.1 Basic Theory of Real Estate Market Equilibrium and the Moscow Case

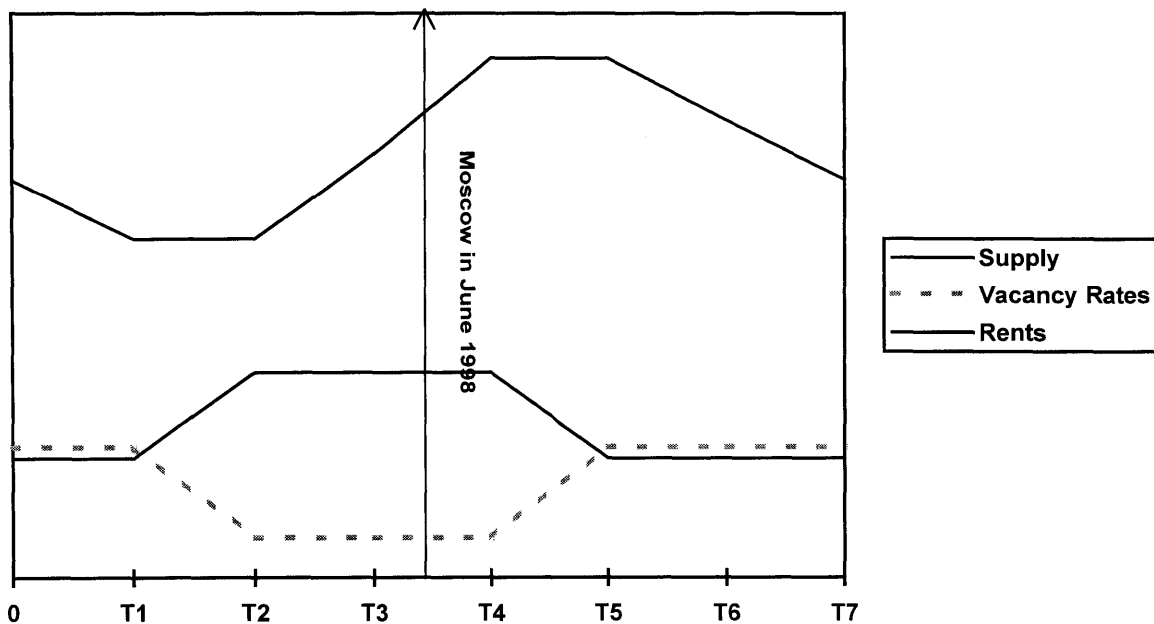
4.1.1 Overview of the Stock/Flow Model of Real Estate Market Equilibrium

According to the stock/flow model of real estate market equilibrium⁴⁴, an increase in demand for space is reflected in increasing rents, as vacancy rates begin to fall and users compete for a limited amount of existing space. Rising rents, in turn, send a signal of strong demand to developers, who in turn react by planning for the provision of new

⁴⁴ Wheaton, William and Denise DiPasquale. 1995 "Real Estate Economics". Unpublished Document.

space. Once additional buildings have entered the market and as the new space is gradually absorbed by end-users, rents tend to level off. This process often causes an over-reaction from developers, all wishing to take advantage of the favorable market conditions.

Figure 4.1: The Real Estate Market Cycle

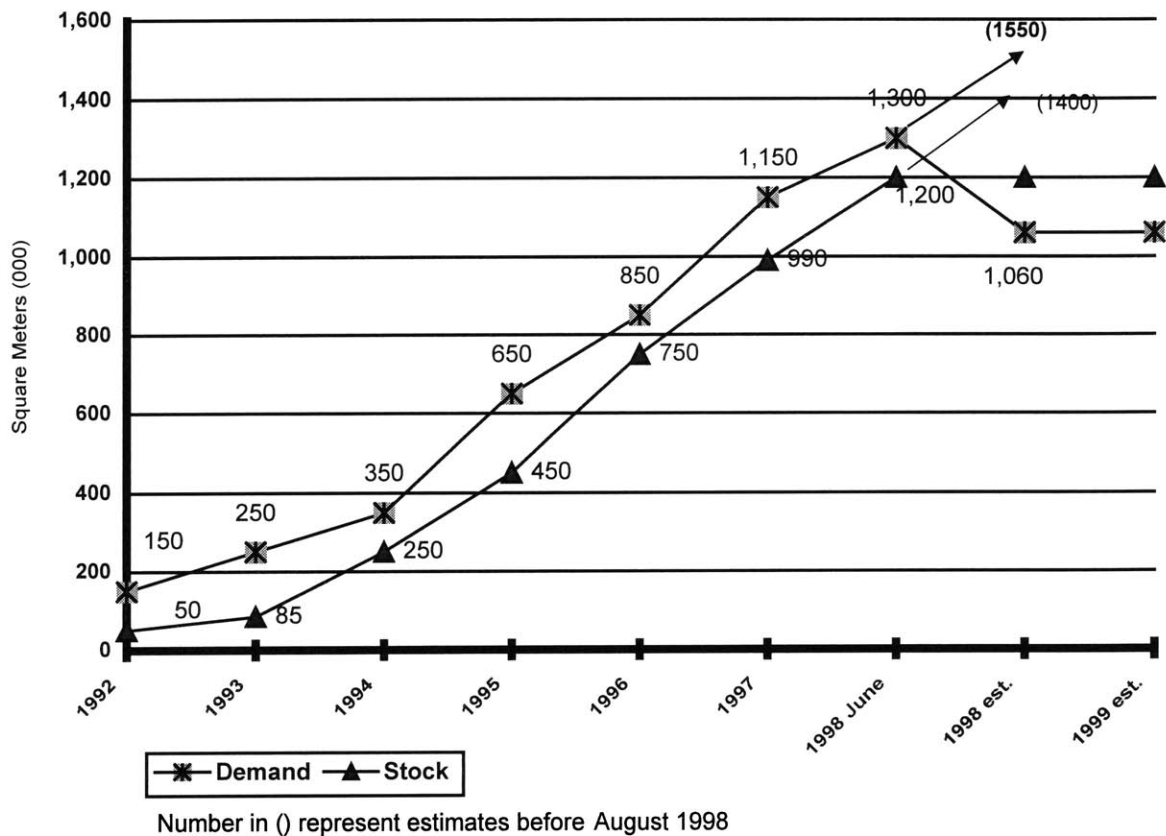


As new developments enter the market, the resulting stock of available space covers and sometimes even exceeds demand at the time. This phenomenon of overbuilding is attributed to the time lag between market signaling and the completion and leasing of new construction.⁴⁵ As soon as tenants become aware of the oversupply, pricing mechanisms again take over the role of signaling changing market conditions. Dropping prices reflect weak market conditions to investors who usually react by canceling their short-term plans for new developments. Market equilibrium is then restored. This is a simplified analysis of the real estate cycle. (Figure 4.1)

⁴⁵ Chinloy, Peter. 1996. "Real Estate Cycles: Theory and Empirical Evidence." *Journal of Housing Research*, vol. 7 issue 2. Washington D.C.: The Fannie Mae Foundation.

Historical information on real estate markets suggests that the cycle just described takes an average of 7 years to complete. In sophisticated and mature markets, this period may be significantly shorter, as developers learn to anticipate reactions and plan for them in advance. In these cases, the adjustment process is usually also less volatile.

FIGURE 4.2: Comparative Analysis of Demand/Stock of Prime Office Space in Moscow (1992-1998)



Sources: The Western Group, DTZ, Stiles & Riabokobytko, Noble Gibbons

4.1.2 The Case of the Moscow Office Market

Consider now the Moscow case. In Moscow we have been experiencing an increasing demand for international quality office premises. These include both type A and B accommodations. In the meantime less than 1 million square meters of total office stock is of international quality while approximately 10 million square meters are of the

classic soviet type (class-C). Conditions of strong demand have persisted since the onset of the market. Throughout this period the market has been experiencing an imbalance between demand and supply (Figure 4.2). At the same time rents continued to escalate, reaching rent levels observed in cities like Paris, London, and Tokyo. According to the above-described stock/flow model of market equilibrium, this should induce enough new development to accommodate all demand. As the market stabilizes, rents can then begin to settle at more realistic levels.

In most countries with free-market economies, this part of the adjustment process takes an average of 2 to 3 years. This period corresponds to the time needed for planning, constructing and leasing a new building. In some of the most sophisticated real estate markets, shortfalls in premises may take as short as 9 months to correct as developers and end-users learn to react on the basis of their expectations on future market conditions⁴⁶ In Moscow, already after 7 years of strong market conditions, supply continued to lag demand by a yearly average of 200 thousand square meters (Figure 4.1/4.2–Table 4.1).

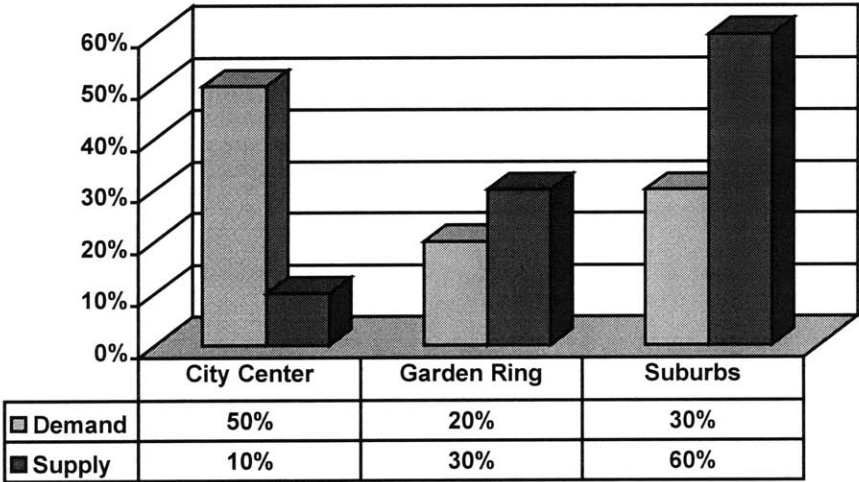
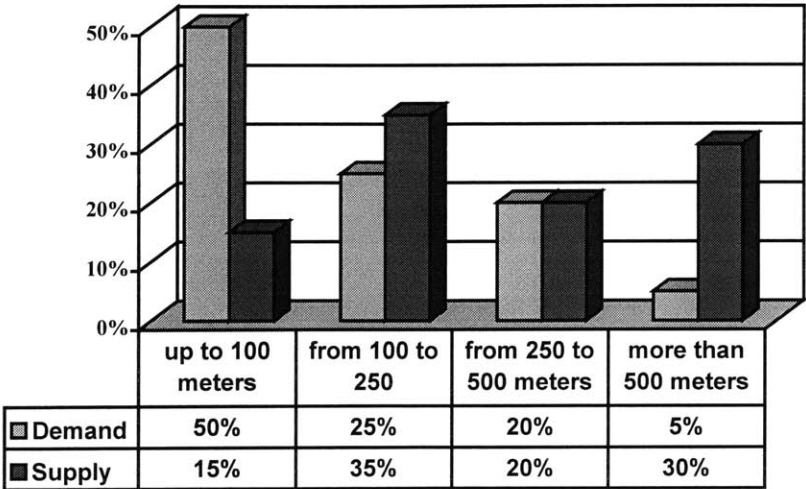
4.1.3 Comparative Analysis of Demand/Stock

By comparing the demand figures from section 2.2 with the corresponding breakdown of office stock presented in section 3.3 we reach the following conclusions:

- a) The greatest imbalance between demand and stock is observed in the market segment for premises of a size up to 100 square meters. These are the premises most likely to host international trade firms.
- b) Quality office accommodations located in the city center is also the market segment suffering most with respect to the geographic distribution of demand and supply. City center locations are again the first preference of trade firms in Moscow.

⁴⁶ Chinloy, Peter. 1996. "Real Estate Cycles: Theory and Empirical Evidence." *Journal of Housing Research*, vol. 7 issue 2. Washington D.C.: The Fannie Mae Foundation.

Figure 4.3: Comparative Analysis of Demand/Stock According to Size and Location of Premises



Source: Moscow City Government. 1995 "Welcome to the Moscow City Realty Market: Prospectus of International Conference "MIPIM 1995" - Mayor's office. Moscow.

Using the 1996 figures on demand and stock of prime quality office space in Moscow we estimate that over 48 percent of the 1997 stock was in shortage when looking only at premises of a size up to 100 square meters and premises located in the city center that year (Figure 4.3). The market appeared to be closer to equilibrium for properties of a size between 100 to 250 square meters , as well as for properties located near the Garden Ring (in both cases supply exceeded demand by some 60,000 square meters).

In terms of the overall market, demand grew according to the estimates at an average rate of 50 percent for the period 1992 to 1997. Average growth of stock for the same period was approximately 75 percent (Table 4.1). As more developments came on the market the gap between demand and supply began to close.

Table 4.1 Growth of Demand/Stock of Prime Office Space in Moscow

YEARS	1993	1994	1995	1996	1997	1998 est.**	1998 end
Demand	66%	40%	85%	30%	26%	26%	-8.6%
Stock	140%	108%	60%	49%	67%	41%	21%
Shortage*	130,000	100,000	250,000	256,000	160,000	150,000	(150,000)

*The third row under the title “shortage” represents the shortfall in the supply of quality office premises.

**This column reports on demand, stock and shortfall in office premises at year end 1998, as estimated before the August crisis. The adjacent column presents current estimates for the office market at year end 1998 based on recent information provided in December 1998 by the Moscow Office Jones Lang Wootton.

Optimism in the market was interrupted in August 1998. As expectations of continuously increasing demand never materialized, and some of the new projects were already in the market the was thrown from one state of disequilibrium to another. In the past 7 years the Moscow city had experienced an undersupply of quality office premises. The end of 1998 finds the market in a state of oversupply of premises, with the class-B premises been hit considerably stronger than class-A buildings (Table 4.1).

4.2 Office Rents and the Market for Prime Quality Premises in Moscow

The purpose of this section is to trace office rents in Moscow for the last 7 years in order to investigate for any inefficiencies in the market signaling mechanisms for changing conditions in demand and supply.

Rent levels in Russia are generally low compared to those in other European countries. Moscow, is the only exception.⁴⁷ Here prices often equal or even exceed office rents at other European capitals like Brussels, London, Frankfurt or Amsterdam. Office rents in Moscow rank fifth in the world, behind cities such as Bombay, Hong Kong, and Tokyo. (Figure 4.4/Table 4.3). Among the top ranking cities Moscow is perhaps the only one having land available for development in the city center. Hong Kong and Bombay are both examples of cities very densely developed due to their geography imposing natural limitations on the supply of land available for expansion.

Rents vary according to class type, level of fit-out provided, and rent prepayment requirements. Before the crisis, rents levels ranged from as high as \$1100 per square meter per year for class-A buildings, to as low as \$400 for class-C type buildings (Table 4.2).

Table 4.2: Moscow Office Rents According to Class Type

Office Type	1997-1998 ¹	September 1998 ²
Class A	650-1100	450-650
Class B	500-900	150-450
Class C	400-750	N/A

¹Source: Stiles & Riabokobylko

²Source: The Western Group/Oncor International, Jones Lang Wootton Moscow.

⁴⁷Perhaps St. Petersburg is the other.

Figure 4.4: 1998 World Office Rents (total occupancy costs)

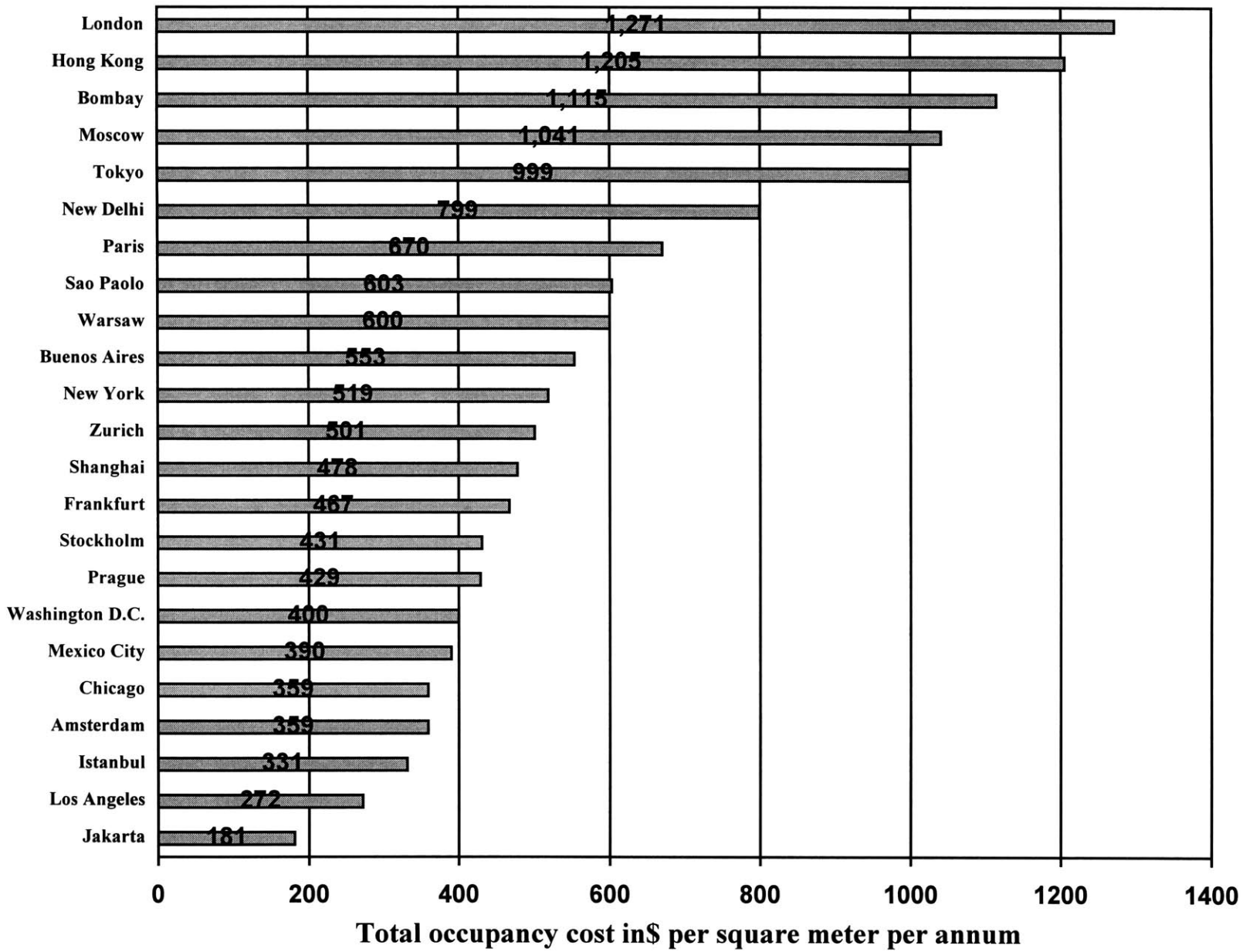


Table 4.3: World Prime Office Rents for 1998

CITY	Population ¹	Total Cost ² USD/sq.m./year.	Leases ³ (years)	CITY	Population	Total Cost USD/sq.m./year.	Leases (years)
Amsterdam	719,856	359	5-10	Moscow	8,581,000	1,041	3 to 5
Bombay	9,909,547	1,115	3	New Delhi	10,000,000	799	3
Buenos Aires	2,960,976	553	3 to 5	New York	8,594,644	519	5
Chicago	7,724,825	359	5	Paris	2,175,000	670	9
Frankfurt	663,952	467	5 to 10	Prague	1,212,010	429	3 to 5
Hong Kong	5,979,000	1,205	3	Sao Paolo	9,393,753	603	5
Istanbul	10,000,000	331	1-5	Shanghai	7,496,509	478	2 to 3
Jakarta	8,259,266	181	1-3	Stockholm	692,954	431	3
London	6,679,699	1,271	15	Tokyo	8,080,296	999	Rolling
Los Angeles	9,198,456	272	5	Warsaw	1,644,500	600	5-7
Madrid	2,909,792	390	3 to 10	Washington D.C.	4,532,662	400	5
Mexico City	9,815,795	390	3-5	Zurich	345,200	501	5

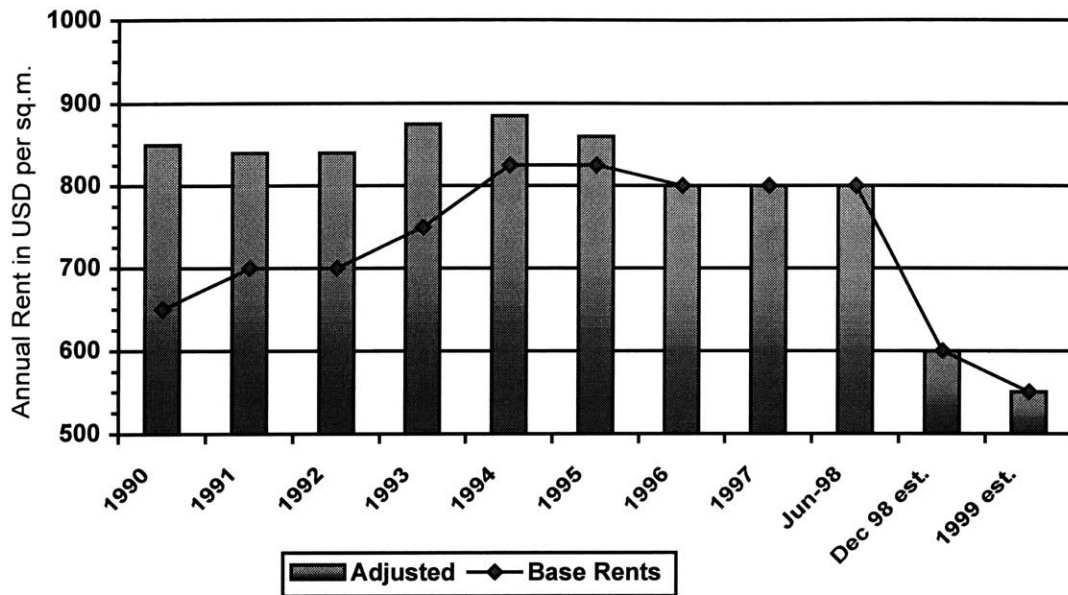
¹Based on information from CACI, The Sourcebook of Country Demographics, Eighth Edition.

^{2,3}Based on CB Richard Ellis 1998 World Rentals Report.

Increased competition for tenants gradually directed Moscow developers towards lease terms similar to the ones found in the West. With lease terms improving and with decreasing prepayment requirements and lease periods⁴⁸, one would expect that over time office rents for international quality office premises would adjust downwards. Yet, during the period of 1992-June 1998 effective rents remained as high as in the very early years of almost no supply (Figure 4.5). During this period, as there was neither land shortage, nor inefficient demand signaling mechanisms in the Moscow office market, persisting high rents most likely reflected the ongoing shortfall of supply.

⁴⁸ Offering even 3-year lease terms at a premium of 10% to 15% over the five year base rate.

Figure 4.5: Base Office Rents in Moscow (adjusted for prepayments)



Source: Stiles & Riabokobylko, The Western Group, Jones Lang Wootton Moscow.

4.3 Tenure Choice and the Cost of Office Space in Moscow

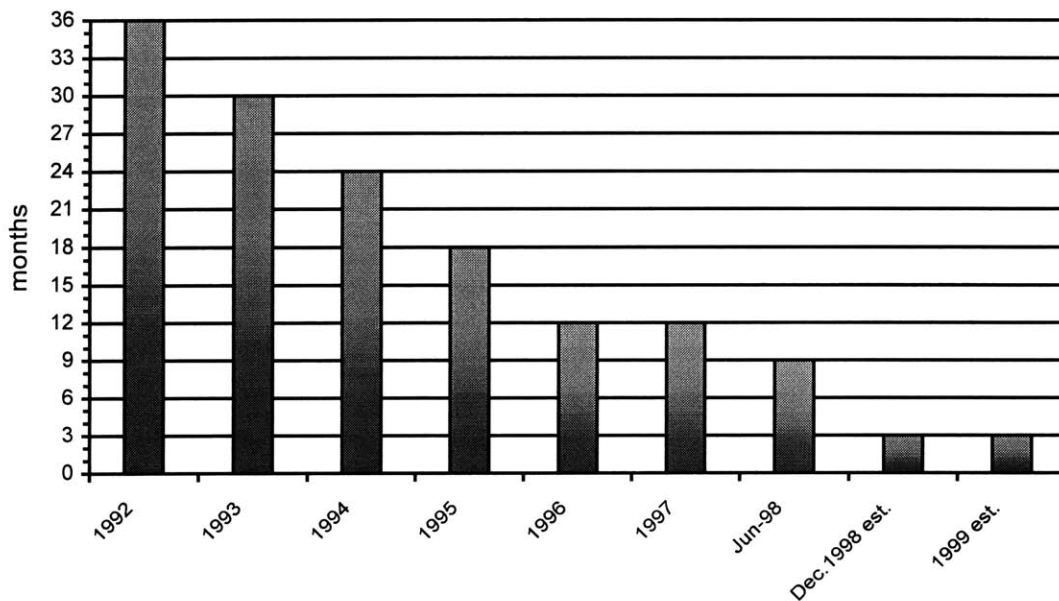
4.3.1 The Impact of Lease Terms on the Cost of Occupancy

In Moscow, when the office market became tighter in 1994, with more demand injected and much of the supply being removed from the market, rents levels peaked. As the inflow of foreign investment continued and international quality space was still in shortage, the cost of purchasing quality office premises came to the price of USD 4,500 per square meter while rents ranged from USD 650 to USD 1,100 per square meter.⁴⁹ Meanwhile, due to the unstable nature of regulation regarding property rights developers sought quick cost-recovery, asking for prepayments in the range of 12 to 24 months' advance rent.(Figure 2.6) Taking rent prepayment requirements into account, the cost of

⁴⁹ According to Stiles & Riabokobylko property consultants, reconstructed properties have been sold in the market for \$3500 per square meter while lease rate for similar class A office premises range from \$650 to \$1100 per square meter.

occupying premises for a period of 2 years amounted to over 50 percent of the purchase price of comparable premises. Under such conditions, some of the firms preferred to give up flexibility and purchase their own office space.

Figure 4.6: Rental Prepayments for Prime Office Space in Moscow (1991-1999)



Source: Stiles & Riabokobylko, Jones Lang Wootton

In 1996, the Moscow rental market for quality office space stepped up considerably. In the second half of 1996, the number of requisitions for lease of office premises exceeded the one for purchase by approximately 2.8 times.⁵⁰ As new developments came slowly onto the market, increased competition for tenants induced property developers and owners to gradually reduce rent prepayments (Figure 4.6). This attracted new tenants into the rental market who in the past may have preferred to purchase their premises. As a result, the rental market for international quality office space experienced a boom, with foreign investors showing a strong preference for newly-

⁵⁰ p. 177, Moscow City Government/Mosvneshinform. 1997. "Business in Moscow Today." Moscow.

constructed buildings located in the city center. Today, the rental market for office space continues to increase at a steady rate, with most trade firms occupying small premises under short to medium term agreements (3-5 year lease terms)⁵¹. Rental prepayments have recently fallen to 3-month levels due to the softening of demand and the availability of empty space ready to be occupied.⁵² In the future, it is expected that rental agreements will dominate the Moscow market.

4.4 Conclusions: The Local Government and Office Market Imbalance in Moscow

In the course of this chapter we have observed the phenomenon of a persisting demand/supply imbalance in the market for prime office space in Moscow. In general, conditions of disequilibrium could be attributed to a number of reasons. One explanation could be that there is not adequate signaling to supply through the market pricing mechanisms. As we saw in the last part of this chapter, this is not likely to be the case in Moscow, where rents have persisted at unreasonably high levels, signaling the degree of office supply shortfall in the market. Another explanation could be that there may not be not enough land available for new office development in the city center and redevelopment may not be possible due to other reasons e.g. condominium ownership of existing buildings. Although this may be the case for most cities experiencing comparable rent levels in the rest of the world, this is certainly not true for Moscow where the socialist regime has left large areas of unused land in the heart of the city. An alternative explanation could be that the office market does not offer returns high enough to attract significant investment. This is also not true in the Moscow market, where developers realize returns over 30 percent on hard capital invested.

⁵¹ Stiles & Riabokobylko/Commercial Real Estate Services. 1996 Office Market Profile: Moscow.

⁵² According to information provided by the Moscow Office of Jones Lang Wootton.

One possible explanation could be that the local government, the administrative body charged with the responsibility of developing and regulating the local real estate market, intervenes in the development process in ways that eventually prohibit the development of an efficient supply sector.

In Russia, the role of local governments is becoming increasingly important and complex as a result of the ongoing process of decentralization. During this process, most of the power previously held by the federal state is now being transferred to the local government or divested to the private sector. The choices of the local government in using the delegated power and responsibilities, have in the past and continue to strongly influence the operation of the local real estate market. What is even more special about the case of Moscow is that, unlike most European countries, where the impact of local government is primarily on design and implementation of development regulation and city planning, Moscow City Government's sphere of intervention spreads as far as to include factors like land administration and management, development financing, and the allocation of building materials.

To investigate further this hypothesis, the remainder of the study (section III) will focus on office development process in Moscow and on the effect of local policies and practices on the supply of international quality new office space in the capital of the Russian Federation. The choice of new development of class-A office premises was made due to the fact that it is the most undeveloped sector and the market segment suffering most from the imbalance. The analysis of problems related to the redevelopment of properties to office accommodations is outside the scope of this study as there are inherently different issues to be addressed in this area which requires a separate study.

Section III

Chapter 5

Decentralization in Russia: the Changing Role of Local Government in Moscow

An important and unduly neglected aspect of the process of transition in Eastern Europe is the extensive decentralization, both political and fiscal, that is taking place in many of the countries newly emerging from behind the socialist veil. Decentralization represents both a reaction from below to the previously tight political control from the center and an attempt from above to further the privatization of the economy and to relieve the strained fiscal situation of the central government. The aspirations of, and the role of, local government are becoming stronger in most of the transitional economies.

The purpose of this chapter is to present the reader with an overview on the decentralization process in Russia, with respect to its impact on the development of a commercial real estate market in Moscow. We will first make a short reference to the changing role of the local government in Moscow. Later, we will discuss the main areas of reform, namely fiscal decentralization, legal and regulatory reform, as well as institutional reform, followed by a few words on the future trends in decentralization in Moscow. The chapter will close with a section on summary and conclusions, where the main question of the thesis is introduced.

5.1 Decentralization and the Moscow Real Estate Market

State and local governments have long been concerned with understanding firm location criteria. This is done within the framework of designing economic development strategies in order to attract firms to their jurisdictions, create jobs and increase municipal income. Such strategies require a good understanding of the comparative advantages of

the specific location and of the corresponding costs and benefits to the firms that consider locating there.

Former socialist countries are only now beginning to realize the power of government policies on demand for the different types of premises. They have yet to understand the impact of the same policies on the supply side of the market. Governments can influence business and household location through the application of economic development principles, taxation policies, financial regulations etc. At the same time, a government may influence the degree and speed of developers' reaction to changing market conditions through the formation of city planning strategies, the provision of zoning and property rights regulations, the development of a property information system, the application of land management techniques, etc.

Political transformation in the Russian Federation has involved a process of fiscal, institutional, legal and regulatory decentralization. And by "decentralization" here we refer to "*the process according to which full decision-making and implementation authority is transferred to local government, which is accountable to its own constituents*"⁵³. "In Moscow, following the federal principles of decentralization, most problems encountered by developers interested in the provision of new quality office space to accommodate the increasing needs of foreign trade firms must now be addressed at the city level.

5.2 Fiscal Decentralization

The central feature of fiscal decentralization in Russia has been the transfer of assets from the federal to the local state. According to this policy, the transfer of all state housing and land to the city level of governance had to be completed by beginning 1991.

⁵³ Bird, Richard and Christine Wallich. 1993. "Fiscal Decentralization and Intergovernmental Relations in Transition Economies: Towards a Systematic Framework of Analysis." Policy Research Economics Working Paper Series, No. 1122. Washington, D.C.: The World Bank.

By transferring the properties, the process of decentralization also transferred maintenance costs for existing structures from the federal to the local level of administration. Fiscal decentralization, as far as it concerns the process of property transfer in Moscow, has been successful in improving the federal deficit by shifting revenue and expenditure responsibilities down to the local level.⁵⁴

The next step following decentralization is privatization. Upon the transfer of a significant number of enterprises and of most land and property to the local level, responsibility for privatization rested with the Moscow City Government. The decision of the Moscow City government to proceed immediately with the privatization of land and property has had a dual positive effect on the city budget by:

- a) relieving the city from the economic burden of maintaining city-owned real estate
- b) generating considerable city revenue from the privatization of existing, finished or unfinished, structures and the sale of land-lease rights.

Despite this, at the organizational level, decentralization has not been able to devolve the desired degree of autonomy, control and accountability over “local matters” to the newly elected local government. This is primarily due to the lack of transparency, clarity of laws, and finally due to the absence of political will.

⁵⁴ The reorganization of the city's tax system within the context of the Russian legislation brought about a rise in the share of local and assessed taxes in the budget revenue by over two times (therefore it does work better locally) As a result of the pushing down of the revenue, the share of the federal budget transfers to the city budget was for 1996 only 6.1 percent. Among non-tax sources of revenue, the highest inflow of revenue will be from the lease of government property, and the sales of municipal property (3.2% and 2.9% respectively), in the total volume of the budget revenue. The Moscow City Government carried out measures for the attraction of additional revenue into the budget, by means of sales of leased property of "unfinished construction" and the sale of land-lease rights. (*Economist Intelligence Unit*. July 4, 1994).

5.3 Legal and Regulatory Reform

The Moscow City Government has made considerable effort to develop and implement an entirely new legal and regulatory framework, in order to provide conditions for the property market to operate efficiently. At the heart of the transformation lies the need to develop and promote better approaches to land issues, with particular attention given to: land tenure, property rights, land-use land redevelopment policies, the management of a public land information system etc.⁵⁵ One of the first challenges has been to design a legal framework which both pays attention to the existing social, cultural, and political realities, and provides a basis for improved land management and development practices.

5.4 Institutional Reform

A major plan for property reform, covering questions of asset allocation, transfer, property use and regulation, with each part integrated into the other, needs a local government with the institutional capacity to implement the proposed policies. While the conventional wisdom once saw implementation as something taking place after a plan or policy is prepared, the problems associated with putting a policy into practice have led to the conclusion that implementation should “*guide the formulation of policy from the outset*”⁵⁶.

Recognizing the need for institutional reform at the local level of administration, the City of Moscow has set up two directives to co-ordinate all actions necessary for the successful design and implementation of land and property reform. The first one is the “Complex for Economic Activity, Property and Land Relations” the second being the “Complex for City Planning and Perspective Development”.

⁵⁵ These issues will be discussed in detail in Chapter 7.

⁵⁶ Hambleton. 1977. “Urban Policy: A Learning Approach.” 63 *The Planner*, vol. 63 p.163-166.

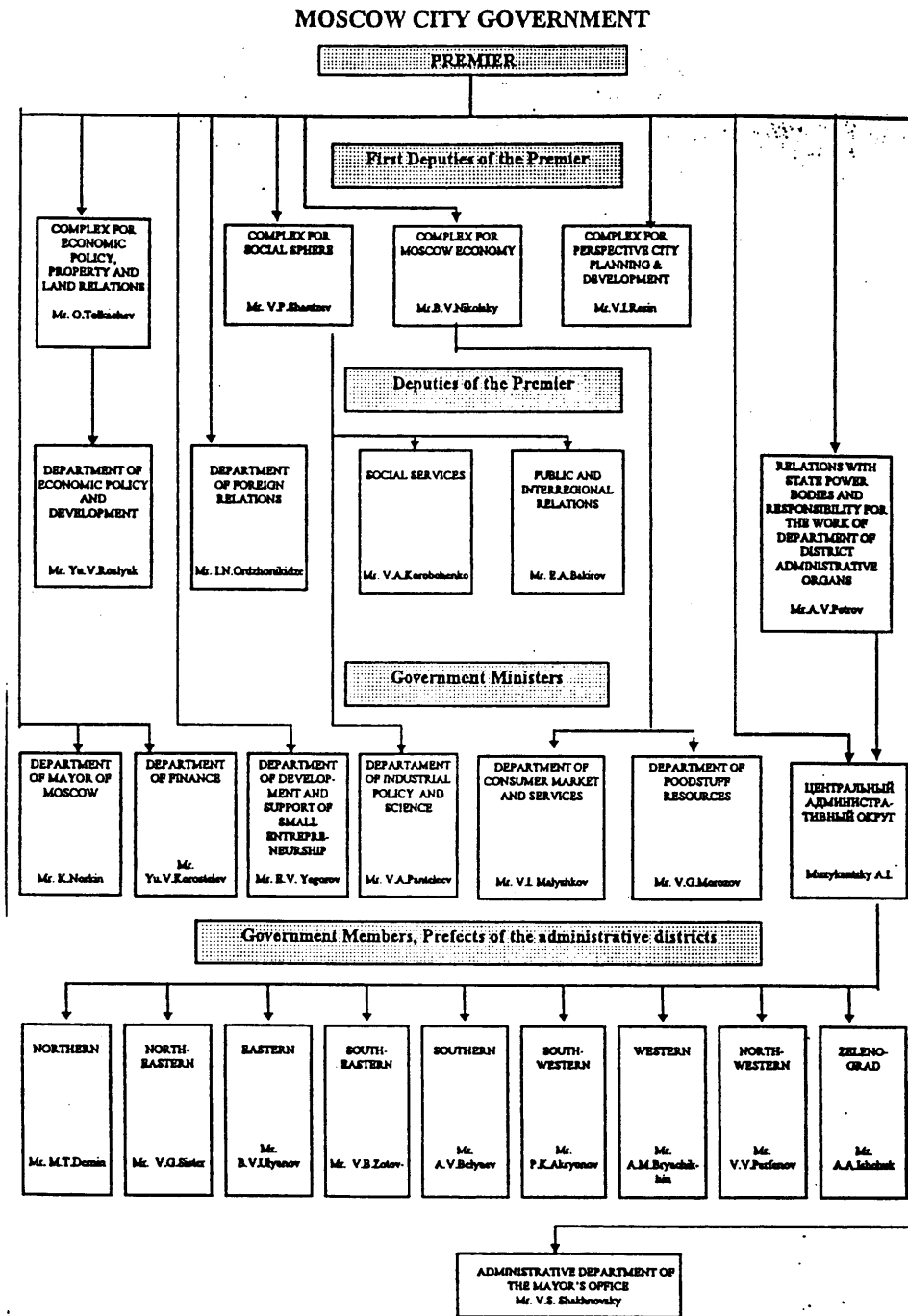
5.4.1 Complex for Economic Activity, Property, and Land Relations

The complex for Economic Activity, Property, and Land Relations has a mandate that covers among other the following areas:⁵⁷

- a) **Land use**: Economic-legal regulation over land use within the framework of realization of the General Plan of Moscow, and control over its implementation;
- b) **Privatization**: Development and realization of the program of privatization of property already in the city ownership;
- c) **Restitution**: Management of the questions of giving (or taking back) plots of land for construction, reconstruction and restoration of municipal objects;
- d) **Municipal property management**: Inventorization, valuation, leasing, sale and delimitation of state property;
- e) **Property taxes**: Perfection of the structure of governing the municipal economy, including realty and land, and
- f) **Property information/registration**: Keeping of the state register of federal, state, and municipal property on the Moscow territory and keeping of the state cadastre of municipal land in Moscow City.

⁵⁷ Mosvneshinform. 1997 . “Business in Moscow Today: Informational-Analytical Almanac”. Moscow. Finances and Statistics.

Figure 5.1 Structure of the Moscow City Government



Source: Mosvneshinform. 1997. "Business in Moscow Today: Informational-Analytical Almanac". Moscow. Finances and Statistics, p. 23.

5.4.2 Complex for City Planning and Perspective Development

As a step towards improving the inherited irregularities in the use of urban land in Moscow, the Moscow City Government has created the “Complex for City Planning and Perspective Development” to undertake the following activities.⁵⁸

- a) **Land reform**, including the design of normative and economic substantiations of land-use, and of location of buildings;
- b) **The management and use of state property** in Moscow (also partly in the mandate of the Construction Complex), the setting and signing of property lease and other agreements with enterprises, organizations, and institutions and the appointment of representatives to the management organs of joint stock companies formed on the basis of a state property;
- c) **The co-ordination of works** for the reconstruction of central Moscow;
- d) **The formation and placing of the city’s capital investment order** for the State needs of the City of Moscow, as well as the city’s order for the supply of goods and services facilitating the stable functioning of the construction complex.

5.5 The Future of the Decentralization Process in Moscow

The main strategy of the Moscow City Government in further reforming the city’s management is the delegation of authority for solving most local problems to the level of municipal regions, accompanied with the creation of self-rule structures at that level. To succeed in this, it is not enough that decentralization redistributes power and responsibilities among the different levels of administration. What is also necessary, is to create the financial and economic conditions as well as the incentives, for local

⁵⁸ Mosvneshinform. 1997 . “Business in Moscow Today: Informational-Analytical Almanac”. Moscow. Finances and Statistics.

governments to accept the resolution of local problems within their own responsibility. According to this plan, the Moscow City wishes to deliberate those questions that cannot be solved effectively at the municipal level, by delegating responsibilities from higher to lower levels and at the same implementing a process of division of powers.

5.6 Summary and Conclusions

In this chapter we have described how property and control over property issues has been divested from the federal to the local level of governance. We have also discussed how the new structure of the Moscow City Government allocates responsibility over land and realty between its different administrative bodies.

In the following sections of this study we will focus on the effect of local policy on the supply of new office space in Moscow. For this purpose we will follow the development process from its very early stages of planning to its final phase of construction. In the course of the analysis we will identify the areas where the local government has been successful in shaping a hospitable business climate in the commercial real estate market, as well as areas where further action is needed. Our question will concentrate on “how” the local government should intervene in order to provide the necessary framework for the efficient operation of the Moscow office market rather than “how much” of government is needed.

Chapter 6

Planning for New Office Development in Moscow

The development of new prime office space in Moscow is the result of the initiative of foreign investors, the Moscow City Government and the domestic private sector. Private companies, whether local or foreign, before entering the Moscow market for office development, need to consider:

- a) Legal and regulatory issues associated with the development process in Moscow
- b) Issues related to the general investment climate in Moscow

This section is intended to cover the basic features of government policy on the establishment and operation of companies for the purpose of office development in Moscow. The first part will cover the rules applicable for company registration and licensing for new office development in Moscow. We will then discuss issues related to taxation and the enforcement of contract Law. The chapter will close with a few words on the support of the Moscow City Government to foreign investment followed by the section's summary and conclusions.

6.1 Company Registration

Any legal entity wishing to undertake real estate activities in Moscow needs to first register and then apply for the corresponding license. Irrespective of the legal form of the entity, it is the local authorities in the relevant geographic jurisdiction that effectuate state registration. Heavy reporting requirements imposed between numerous government bodies involved in the registration process has forced the required set of documentation to be very long and detailed.

For foreign companies wishing to set up operations or a joint venture in Moscow, the registration process is more tedious because of additional legal requirements and

procedures involved.⁵⁹ There are three government authorities involved in the pre-incorporation approval and registration process, one local, the Moscow Registration Chamber, and two federal, the State Registration Chamber and the Anti-Monopoly Committee. This increases the amount of bureaucracy, making the process costly and time-consuming.

6.2 Licensing of Activities

Once registered, a company then needs to apply for all necessary licenses. Real estate development falls in the list of 29 types of activity, subject to licensing on the territory of Moscow.⁶⁰ Licenses already authorized by the Russian Federation must also go through an application process for registration in the City of Moscow. Procedures for issuing licenses in the City of Moscow are relatively standardized with some exceptions. Much of the complexity in the licensing process is caused by the fact that there are 15 different organizations engaged in licensing activities in the city. To improve licensing administration, the Moscow City Government is now moving towards a centralized system to be carried out by the Moscow Licensing Chamber.⁶¹

Obtaining approvals and permits for a particular project appears to be one of the greatest hurdles in the planning process for foreign developers. All of these approvals are granted by the local government. The current policy requires a long list of permits including permits from the Moscow Architecture Office, the Moscow Committee on

⁵⁹ The procedure for the creation of enterprises with foreign investment on the territory of Moscow which use the city property is indicated by the enactment of the Government of Moscow "On Perfection of Creation, Registration, Recording and Monitoring of Activities of Enterprises with Foreign Investment, which use city (Municipal) Property", date 1992. Source: Moscow City Government/Mosvneshinform. 1997. "Business in Moscow Today: Informational-Analytical Almanac". Moscow. Finances and Statistics.

⁶⁰ This list includes "realtor activity" as well as "planning and prospective works related to utilization of land".

⁶¹ According to the Ordinance of the Government of Moscow No 699 "On Improving the System of Activities on the Territory of the City of Moscow", dated 15 August 1995.

Land, and the Moscow Property Committee. To obtain a permit from the Moscow Architecture Office, a developer needs to involve a local architect during the application process. In order to avoid potential delays associated with the licensing and planning process, foreign developers often look for a Russian partner, familiar with the local “channels” of conducting business, who has the necessary contacts to facilitate the planning process.

To improve on the process, the Moscow City Government is elaborating an Ordinance aimed at preventing an excessive number of contacts between developers and civil servants at the permit-obtaining stage. Under the new system, the developer will have to officially submit to the authorities basic information about the proposed project. Then the appropriate city bodies will issue the complete package of permits and approvals.

Licensing for construction appears to be a less troublesome area in the process of new office development. Only in 1995, the Moscow Center for Licensing Construction Activities, an entity authorized by the Moscow government, issued approximately 10,000 licenses for construction and project works.⁶² In the same year, no more than 30 licenses were canceled or suspended. In the future, developers and contractors are likely to be faced with more stringent criteria for licensing of construction as the local government adopts and enforces western standards, rules and regulations for construction. Until then, local officials will continue to capitalize on the lack of transparency of the current system of registration and licensing procedures.

6.3 The Taxation System

The federal and local taxation systems in Russia are aiming at the creation of equal treatment of Russian and foreign companies involved in the realization of goods,

⁶² Moscow City Committee of State Statistics. 1996 “Moscow-1995: Statistical Collection”. Moscow.

works and services in the country. One of the results of the recent process of decentralization, has been the considerable increase in the number of taxes applicable in the Moscow territory. Presently, there are 16 federal, 4 subnational and 23 local taxes imposed on enterprises carrying out commercial development activities in the capital of Russia.

Local taxes give particular weight to resource payments regulating property relationships and reproductive economic processes in Moscow. For this purpose they include property and land taxes on natural and legal persons, as well as a registration charge. The Land Tax sets forth land tax rates that differ by territorial and economic zones within the city.⁶³

The current taxation system, consisting of three layers of taxation, the federal, sub-national and local is complicated and extremely difficult to use because of its contradictory bulk of legal information. Investors are also discouraged by the system of taxes being constantly redesigned and amended. In addition to the general problem of the instability of the tax system, there exist a number of specific tax problems related to commercial real estate development:⁶⁴

- a) Russian tax-deductible depreciation rates are very low. The typical rate for buildings is 1% per annum;
- b) Under Russian law, interest on loans to acquire fixed assets is not tax deductible;
- c) VAT on construction costs is irrecoverable;
- d) VAT recovery for the landlord depends upon the type of tenant;
- e) Under Russian law, income paid to a foreign company is subject to a withholding tax of 20%. While double-taxation treaties may reduce or eliminate withholding tax on

⁶³ "On Land Tax Rates on the Territory of the City of Moscow" dated 1994.

⁶⁴ Forbes, John of Coopers and Lybrand. 1998. "Tax Perils, Pitfalls and Planning Opportunities". Article published in *Estate News Moscow Supplement Spring 1998 Issue*, p. 20.

dividends (usually at 15%), no tax treaty eliminates withholding tax on rent from immovable property.

Apart from its design, another troublesome area of the Moscow taxation system is related to its administration. In the past, there had been a mismatch between the administration of tax assignment and tax collection. A federal administrative body, the State Taxation Service, conducted the collection of both federal and local taxes. In the old system, local taxes were not collected properly as the collection agency, being a federal organ, gave priority to the collection of all federal taxes. Today, Moscow is moving towards an independent system of local tax administration. The effectiveness of the newly proposed system will rely on the ability of local officials to acquire the necessary skills for carrying out effective tax administration.

While the principles of the new system are being established during Russia's transition period to a western-type economy, the country, unlike other countries in Central and Eastern Europe appears to have difficulty taking guidance from western taxation practices. Given the constantly changing nature of the tax and legal systems, real estate investors are often left with highly complex structures, set up to avoid a particular problem from five years ago, but which are inappropriate for the problems of today.

The taxation system in Moscow requires simplification. One of the issues still to be resolved regarding taxation is the need for a clear separation of spheres of responsibility between the different levels of government. Technical assistance should also be provided to improve the tax administration and collection within the local government. Tax rates must be lowered in order to reduce tax evasion and increase tax payments inflow. Today, although the tax penalty regime in Russia is draconian, the majority of businesses are currently trying to avoid them. At the same time that tax authorities are striving to get as much tax revenue possible from a very narrow base. Tax pressure is very high, particularly on the growing foreign sector of the economy. This

introduces large inefficiencies in the market for commercial real estate development, causing large differentials in contractor's bids, depending on the level of taxes each contractor chooses to pay.

This year, a new Tax Code is likely to be approved. If so, it will come into force in January 1999. The Code will introduce a new form of local tax, levied on the ownership of real estate by individuals and legal entities. The basis will be the market value of the property as determined by the local tax authorities and the maximum tax rate will be 2%.⁶⁵ From the city's perspective, this tax will be a major source of revenue for the local administration and should operate as an incentive to elaborate a complete cadaster. From the investor's point of view, this new tax will work as a disincentive for new development. It is also hoped that the new Tax Code will introduce a more favored treatment of construction costs. In the meantime, it is vital for any developer or investor to structure the project in a way that is flexible and adaptable to changes in the existing tax system.

6.4 The Enforcement of Contract Law

The current law governing contractual relations is generally regarded as insufficient. Most contractual agreements established between private parties rely primarily on personal relations. Due to the inefficiency of the existing court system, contractual parties assign arbitration courts often in jurisdictions outside the country in cities like Stockholm or London. Lately, an arbitration court was set up in Moscow the effectiveness of which is largely questioned. In practice, most conflicts are usually settled outside the court. Conflict resolution between a private party and the Government is usually carried out through "unofficial" channels. Conflicts between private parties are

⁶⁵ Moore, Adrian and Marrio de Echevarria of Baker and McKenzie. 1998. "Status of Reform in the Russian Real Estate Market." *Estate News* Moscow Supplement, Spring 1998 issue.

in most cases resolved by “protection rings” determining who is right.⁶⁶ For any out-of-court settlement it is necessary to first initiate the required arbitration procedures.

6.5 Moscow City Support to Foreign Investment

The local government has made positive steps in the area of protection of foreign investment. Overseas capital in Moscow is protected not only by federal legislation but by other local measures as well. As a Federation member entity, Moscow has the right of independent foreign economic activities. According to the Constitution, the city can pass municipal laws and bylaws to improve the investment climate. For this purpose, the Government of Moscow passed a decree in 1995 securing extra guarantees to foreign investors by providing credit deals, based on mortgages on city-owned real estate. It is also planned to establish Moscow municipal insurance funds in overseas banks to be used instead of federal government guarantees.⁶⁷

6.6 Summary and Conclusions

Unclear, conflicting and cumbersome procedures in registration and licensing in Moscow have until today allowed corrupt behavior to play a decisive role in getting office developments off the ground. The situation is further aggravated by a “tradition” of local businessmen accustomed to working through illegal channels. Meanwhile, foreign investors, not familiar with such practices often team up with a local partner to assist them with administrative hurdles. A good architect, able to push the papers through quite effectively can sometimes also provide such services.

The normative and legal basis of the taxation system is currently being formed in Russia, yet is still far from meeting requirements of value, completeness, and non-

⁶⁶ A network of influential people working within or in proximity to the local government.

⁶⁷ More details on these policies will be provided in Chapter 8.

contradiction. Open discussion about bribes and illegal ways of optimizing taxes are common to local developers in Moscow who “often do not hesitate to offer bribes even when there are serious professional objections against their projects”.⁶⁸ A significant issue at present is the potential impact of the proposed new Tax Code. Attention should be given to the structuring of new projects so that they can take advantage of possible improvements in the tax system when they are introduced.

One of the major weaknesses of the current system arises from the difficulty of the parties to enforce contractual rights. The inappropriateness of the Contract Law, combined with long periods of waiting for a case to be brought before Russian court have given rise to alternative methods of conflict resolution that usually involve the unofficial intermediation of the local government.

While the city is making considerable efforts towards the protection and promotion of foreign investment in Moscow, the cost of setting up operations for an international developer may vary widely from case to case. Until then, the much-desired “national treatment” of investments involving foreign capital is still something to look forward to.

⁶⁸ Opinion of legal advisor Cameron Sawyer of Sawyer & Co expressed during the first professional round table on foreign investment in Russian real estate organized on the 26th^{of} January 1995 on the premises of Krest Development by the “Investor’s Association of Moscow” and published thereafter in article under the title “The Russian Real Estate Market” p.11 of *Project Russia: architecture, urbanism, design* magazine issue No.3, September 1995. Moscow. A-fond.

Chapter 7

Land Acquisition and the Land Market in Moscow

7.1 Introduction

In a market economy, land price differentiations constitute the most important factors determining quantity and location of land consumed. Inefficient land markets are considered obstacles to the development of commercial real estate. Security of tenure is strongly linked to land rights, in absence of which, raising development financing becomes a very difficult and costly task. The total commitment to public ownership of land under the administrative command system of economy has led to a dramatically different structure of socialist cities. Chronic shortages of developable land created by regulations, restrictions and controls over land use, have inevitably triggered the rise of an illegal informal sector to compensate for the rigidity of the formal one. The development of urban land markets is the only way to remedy past urban distortions.

The purpose of this chapter is to investigate the effect of government policy on the supply of land for new office development in Moscow. The reader will first be presented with a description of the Moscow land market, followed by an overview on the division on power between the federal and local administration with respect to land issues. We will then move to evaluate the progress made to date on the three preconditions for the operation of efficient land markets. The first is related to the establishment of the necessary legal framework to govern land rights in Moscow. The second involves the process of land privatization. The third precondition refers to the creation and use of a land registration and information system. At the end of the section we will summarize the most important conclusions from this chapter.

7.1.1 The Land Market in Moscow

In Russia, administrative decisions based on "need" have until recently governed the use and quantity of land consumed. The fact that urban development took place in a period when land was nationalized and administratively allocated rather than sold on the open market has had a profound impact on the spatial organization of Russian cities. The inability of the administrative-command system to assign land values has generated striking spatial anomalies throughout the Russian urban territory. High spot prices for new office space in Moscow are only indicative of the acute supply constraint for land dedicated to services in the city center, a common phenomenon in socialist cities.

The structure of the Moscow primary market for land plots is as follows:⁶⁹

- Most demand is for land to accommodate development of high-quality office premises and housing. Demand for such parcels is steadily increasing. Small and rather inexpensive plots of land for quick recouping business (trade pavilions, fuel stations, etc.) are in stable demand.
- Looking at the supply side, the development of "industrial belts " within 4 to 8 kilometers from the city center in the past has left obsolete and low-density activities on accessible and well-serviced land in the city center. The most common size of plots available is of over 0.5 hectares (34%) or from 0.1 to 0.3 hectares (31%).⁷⁰ Most parcels offered are located within the Garden Ring.⁷¹

The Moscow City Government has adopted an urban development policy according to which the target destination of plots of land comprises of 42% land plots for administrative-office buildings, 36% of plots dedicated to dwelling houses, 12% of plots

⁶⁹ "Moscow Property: Finding the owner and interests of the City". 1995. Scientific and practical collection. *Russian Economic Journal and Delovaya Lega* issue 1.

⁷⁰Of available plots, 19 percent cover an area of under 0.1 hectares while only 16 percent of the parcels have a size of 0.3 to 0.5 hectares.

⁷¹ Of vacant parcels, 64 percent are located within the Garden Ring with the remainder 36 percent found outside central Moscow.

offered for trade premises and the remainder 10 percent allocated to other facilities. However, the city has not yet developed the necessary zoning regulations to regulate the implementation of this policy.

Although there appears to be enough vacant land for commercial development in the Moscow, land market conditions discourage the construction of new office premises in the city center. There are three major pre-conditions for the development of an efficient land market in Moscow:

- a) The establishment of the appropriate framework regarding property rights on land;
- b) The disposal of unused pieces of land from the public to the private sector under a privatization scheme;
- c) The creation and enforcement of a land registration and information system.

7.1.2 Division of Power and the Land Market in Moscow

Earlier in this study⁷² we saw how responsibility for a number of issues related to property has gradually shifted from the federal to the local government. This action remains one of the core instruments of decentralization policy in Russia, with its primary objective being the transfer of the budget responsibility to the city level. However, recognizing the importance of land policy in transitional economies as an income redistribution instrument, the federal government has reserved the right to exercise control over issues related to land and realty. In particular, according to the Constitution of the Russian Federation⁷³, issues falling under the joint jurisdiction of the Russian Federation and the local administration, include:

- Issues related to the possession, use and disposition of land, subsoil, water and other natural resources

⁷² Chapter 5.

⁷³ Articles 71-79 of the Constitution of the Russian Federation .

- Delimitation of state property

Joint responsibility over Moscow real estate is accompanied by a dual legislative system, consisting of over 30 acts (federal and local), continuously being amended and often contradictory. Many of these acts are not effectuated due to the lack of institutional capacity to implement them. Due to the fact that there is joint control over a number of regulations related to land administration in Moscow, in the following sections of this chapter it will be of essence to examine both federal and local practices. This will help the reader understand better how the two systems interact with each other and their effect on the operation of the Moscow land market.

7.2 Property Rights on Land

In this section our discussion will focus on the first pre-condition for the development of a land market, namely the establishment of the necessary legal framework regulating land relations in Moscow, with particular attention given to property rights on land. The discussion will begin with a short reference to property rights in general. We will then shift our attention to land rights in Russia, the legal system regulating them including the Land Code, being most important piece of legislation on land. Finally, we will examine land rights in Moscow.

7.2.1 Property Rights

In a market economy, "private property" means that the "proprietor" has the "exclusive rights" to use and transfer his or her property and to realize returns guaranteed by law (Boeble, I. 1988). In stressing the importance of private property rights, policy makers sometimes go as far as to consider the degree to which property rights are defined, as a measure of how optimal and effective a legal system is.⁷⁴ Unclear property rights often result in wasted money and time on negotiations and conflict resolution. In order to minimize economic inefficiencies, countries need good legislation and a court system that enables property rights to be protected without undue expenditures. In addition, stability of property rights must be ensured. Under these conditions, the proprietor has the incentive to allocate his property efficiently and to spend part of his returns for the maintenance of his assets.

In Russia, according to federal legislation, buildings and land are to be treated separately, governed by different sets of rules. This study focuses on the problems encountered in the development of new office space in Moscow. Our discussion will therefore concentrate on property rights on land, with some necessary references to other types of property rights.⁷⁵

7.2.2 Land Rights in Russia

One definition of land rights proposes that *"the principal rights in land are traditionally related to the use and possession of a land parcel in its present physical state, to the power to change its physical attributes (by improvement, maintenance, or neglect) and to the ability to transfer these rights of use, possession and development"*⁷⁶.

⁷⁴ According to Michel Camdessus, Executive Director of the IMF as expressed in an interview in *Business in Russia*, Issue September-October 1996. "Special Edition: Russian Realtor."

⁷⁵ Property rights on buildings will be discussed more elaborately in Chapter 8 on Financing.

⁷⁶ Pearce, B.J. 1980. "Instruments for Land Policy : A Classification". *Urban Law and Policy*. Issue 3.

In Russia, ownership of land is a norm established by the Constitution⁷⁷, yet remains one of the most complex areas in the property law. Today, the Civil Code of Russia reproduces the constitutional provision on the equality of all property forms - private, state, municipal and other. Although the same document declares the existence of rights of ownership “and other rights to things in relation to land”⁷⁸, this chapter will only come into force upon adoption of the new Land Code in Russia. In the meantime, local governments are allowed to pursue their individual land policies. Federal laws allow foreign investment in Russia to take the following forms:

- Acquisition of rights governing the use of land and other natural resources
- Other activities to carry out investments...including...rights to real estate

Although federal laws proclaim “national treatment”⁷⁹ of foreign investment, current legislation stipulates state control over foreign investments and renders impossible for foreigners to acquire terrain as property or as inheritance. Meanwhile the federal law that originally limited all land leases to a maximum of 49 years has been abolished, allowing Russian legal entities to own land outright.

Such restrictions over freehold ownership of land are often referred to as the main deterrent to foreign investment in the Moscow office market.⁸⁰ While the past few years have seen some major steps towards the establishment of land rights, actual ownership is far from resolved.

⁷⁷ Article 36, paragraph 1 of the Constitution of the Russian Federation.

⁷⁸ Part 1, Chapter 12 of the Civil Code of Russia.

⁷⁹ The Russian federal law “Concerning Foreign Investments” proclaims that “*the regime for foreign investment and activities of foreign investors cannot be less favorable than the regime for property, property rights and investment activities of Russian citizens and legal entities*”.

⁸⁰ According to Adrian Moore of the Moscow office of Baker and McKenzie as expressed during the “Moscow Investor’s Association” round table discussion organized in 1995 in Moscow the proceeds of which were published in “Project Russia: architecture, urbanism, design” magazine issue No 3, p. 11 September 7, 1995.

7.2.3 The Land Code

The development of the Land Code has constituted one of the most controversial pieces of legislation in Russia. Much of the dispute comes from the potential impact of the Code's content on agrarian reform. First, a draft Land Code, prepared by the Agrarian and Communist parties and regarded by reformers as conservative and market-restrictive, was vetoed by President Yeltsin during Summer 1997, after passing in Parliament. Later, the Duma failed to override the President's veto. The draft was therefore back in the Duma for several months.⁸¹ In the meantime, many regions have been passing their own legislation allowing the sale of farmland, the political issue preventing the Code's passage.

Today, the legal framework covering private ownership of land is still in the development stage while restrictions remain on the right to purchase land. A number of other important pieces of legislation affecting commercial real estate development depend on the Land Code. These include Chapter 17 of the Civil Code also dealing with land ownership and land transactions, the law on cadaster, and the law on mortgage. The conciliation commission appointed to resolve the deadlock has reportedly made little progress to date. In the interim, it is hoped that the revised draft, when produced, will be less agrarian-based and more market-friendly, eliminating restrictions on foreigners owning land and providing some sensible regulation on city land development.

7.2.4 Land Rights in Moscow

In Russia, it is common to have the legislative and executive powers of the different levels of government pass laws and decrees on the same subject which are in

⁸¹ According to the article of A. Moore and Mario de Echevaria of Baker and McKenzie "Status of Reform in the Russian Real Estate Market", *Estate News Moscow Supplement*, Spring 1998.

conflict. Land rights in Moscow is one of the subjects where federal and city law is in conflict. According to the local legislation, Moscow land is not transferable to anyone's ownership. The right of ownership to buildings, construction and structures does not imply the rights to ownership to the land plot under the structure.⁸² Contrary to the federal state, the Moscow City Government currently has a policy of retaining the freehold interest in its land, irrespective of whether the potential owner is Russian or foreign. Other interests on land are legally permissible, the most common currently granted being a long lease. Foreign entities are often struck by the separate treatment of buildings and land in Moscow. Whereas it is generally more common for a foreigner to acquire land on a 49 year lease, the laws governing buildings and structures are less restrictive, allowing ownership by foreign persons.

The design of normative and economic substantiation of land use including issues of land reform in Moscow, is one of the tasks performed by the Complex for City Planning and Perspective Development.⁸³ In absence of land ownership rights, property policy in Moscow focuses on the disposition and control of land use rights. The entity responsible for the economic and legal regulation of land use rights in Moscow and for control over its implementation is the Complex for Economic Policy, Property and Land Relations of the Moscow City Government. Although the current legal system on land rights is designed to guarantee an equitable treatment of foreign and Russian entities in Moscow, local authorities often exercise discriminatory treatment against international developers.

⁸² According to the Decree of the Mayor " On certain Issues of Regulations of Land and Property Relations in the City of Moscow" dated 17 January 1994.

⁸³ Refer to chapter 5 for complete description of tasks.

7.3 Land Leasehold in Moscow

In this section we will take a closer look at the only available system of land-acquisition in Moscow, the system of public leasehold, with particular attention with to discrepancies between law and implementation. Our discussion will begin with a short description of the public leasehold system in general. We will then continue by focusing on land leases in Moscow.

7.3.1 The Public Leasehold System

Under a formal system of public leasehold, the state holds onto the freehold interest on land, with private agencies taking leases that can be assigned to third parties. These agencies develop and manage their land-holdings according to express covenants. The difference between title and lease is that title is perpetual in nature and includes rights to possess, use, transfer, mortgage and derive income from the property. A lease is time bound and its primary function is to provide user-rights, particularly the shorter the term of the lease. If the leases are longer term, they may also include rights to mortgage.

A leasehold system may take different forms, depending on the extent of control it provides and the duration of this control. An important distinction exists between temporary and perpetual (no firm pre-set reversion date) leases. In Poland, perpetual leases confer a contractual right to use, manage and administer the state-owned land for a minimum of 99 years. While extension of the lease is usual, the rights of perpetual usufruct may also be sold, leased or inherited.⁸⁴ The assignment of a lease by the tenant is a transaction commonly carried out in perpetual leaseholds. In such case the usufructurer pays for the use and must clear all planned improvements with the government.

⁸⁴According to Baker and McKensie's "Business Leases in East and West Europe" 1996 report.

The system of land leasehold is popular in many countries of the former Central and Eastern Europe including the Ukraine, Latvia, Lithuania, and the Czech Republic.⁸⁵ Leaseholds in these countries differ as to the length of the term and the rules applicable on foreign entities. In Romania, Slovakia and the Czech Republic, foreigners have the right to lease land as a foreign legal entity or to own land through a locally incorporated entity. In countries such as Latvia, Lithuania and Belarus, foreigners are only allowed to lease land for a period of up to 99 years. In Ukraine, lease rights may only be granted on land for a period of up to 50 years.

There are a number of reasons for the public leasehold system being so popular in such countries. First, local governments, by holding a superior interest in a land parcel as, for instance, in the relationship of landlord and tenant, they can impose obligations on the holder of the inferior interest. Second, by using property rights over a particular land parcel in the present, their decisions can affect the possibilities governing subsequent owners. Finally, by owning and using rights in one land parcel they may be able to influence the decisions made on the use of adjacent land holdings.⁸⁶

Being able to impose restrictive and positive covenants allows a local authority to regulate the use of property rights and impose specific duties on land-holders⁸⁷ in ways which often central government universally applied legislation does not cover. As the freehold of the land remains in their hands, the local government can be assured of maintaining the use of these extra controls over a longer period of time. A particular advantage of the leasehold system is that -in theory at least- any increases in land values can be captured by the public authority through changes in ground rents. These gains can then be returned to the community that was most probably largely responsible for them.⁸⁸

⁸⁵ Economist Intelligence Unit, 12 December 1995.

⁸⁶ Pearce, B.J. 1980. "Instruments for Land Policy : A Classification". Urban Law and Policy. Issue 3.

⁸⁷ the requirement to maintain buildings, control over the demolition of buildings, and control over the occupants of a land parcel

⁸⁸ See D.R. Denman, *supra* n.4, Chapter 7.

7.3.2 Land Leases in Moscow

Russian legislation governing land ownership permits legal entities to exercise all forms of property rights, such as lease and rights of use, other than absolute ownership. Whilst most investors would prefer to own land outright, there is still a great potential for profits made in commercial real estate development if a long-term land lease can be obtained. Leases on land are usually much simpler than in the West, due to the generally inefficient enforcement of contractual rights in the Russian court system and the lack of a codified system of rights and obligations to govern landlord-tenant relations. Hence, Russian leases tend to reflect the importance of personal relationships between the landlord and the tenant, the guarantee of a peaceful tenancy in Russia today.

The Moscow City government has a standard form of land leases whose terms are usually open to negotiations. In an effort to minimize the difference between leasehold property and possession of land, the local government leases out land for a term of up to 49 years. Although 49-year leases are currently the norm, a provision may well be accepted entitling the investor to a unilateral right to renew the terms of the lease without obtaining the lessor's consent. The city government will also often accept wording in the lease entitling the investor to convert his leasehold interest into outright ownership if it becomes possible by law to do so.⁸⁹ Careful thought should however be given to the drafting of such clauses and in particular the mechanism of calculation of the payment for converting the outright ownership.⁹⁰

According to the rules specified in the 1992 decree "On Payment for Land", the use of land in Moscow shall be paid for in the form of rent applicable on land lessees or in the form of a land tax applicable to all other land-owners, land-holders and land-users.

⁸⁹ According to Ben Morgan of Norton Rose as expressed in his article "49 Year Leases and Security of Land Tenure" published in *Estate News Moscow Supplement* Spring 1996 Issue.

⁹⁰ A popular formula is to refer to the then market value of the land, less any payments already made in respect of rent and premiums.

The amount of payment is imposed in the form of fixed payments per square unit of land annualized. Investing in leases can -in general- be worthwhile, as land leases are commercialized at often double the initial price acquired.

In the absence of zoning regulations, the cost of land leaseholds is not related to the destined use of the corresponding parcel. Land-use rights are negotiated separately with the local government. The acquisition of land-use rights is a major source of delay and cost in the development process. It also carries a high level of risk, as it is not only the local government that regulates land-use rights, but also the “informal” sector as well. Furthermore, the duration of the granted land-use rights may often be shorter than term of the land lease. In essence, the local government reserves the right to change land-use rights at its discretion. This is a major barrier to mortgage financing of commercial properties.

The nature of the vehicle holding the lease is also an important issue. As it is not possible to simply purchase land freehold, there are a number of structures possible, such as co-operation agreements with the ultimate ownership being the 49-year lease. Land lease rental rates in Moscow are substantially higher for foreign entities or Russian companies with foreign participation. In such cases, the right to purchase a 49 year lease in the City of Moscow can cost as much as \$20 million for a hectare of land. For this reason, large projects are often done in joint ventures, where investors are working with the government but maintain buyout rights.

Regarding the transferability of land lease rights in Moscow, the ongoing liability of an original lessee under a lease, even if it is assigned, is something that the Moscow City Government may be persuaded to waive. This is often conducted by arguing that on assignment of the lease, the city will release the original lessee from any further liability. Alternatively, the city may agree to the original lessee having a unilateral right of termination of a land lease. Many developers that intend to sell all their building on the

land and retain no further involvement in the development usually consider negotiating the latter.

The laws on public leasehold in Moscow permit administrative action with few if any safeguards against abuse of power and with little effort to ensure the payment of fair compensation. The system lacks administrative fairness where due compensation is paid promptly and in full, where there are proper internal checks on planners and administrators to ensure that they carry out their duties properly, and where there are adequate external checks to investigate allegations. There is clearly a need for fundamental change, consisting of a planned program of major land reform. This reform needs to cover questions of tenure conversion, allocation, transfer, regulation, and use, with each part integrated into the others. What happens in Moscow is fundamental reform on an incremental basis.

7.4 Privatization of Land

In order to understand better the system of land privatization we first need to look at how responsibility on Moscow land is delimited among the different levels of government. Having presented the legal framework on land privatization, the next part provides the reader with an overview on the basic features on the land privatization methods used in Moscow. The section closes with a few words written on the role of politics in the process of land reform and land privatization in Moscow.

7.4.1 Delimitation of State Property

During the period of the Soviet Regime, all immovable property, including land and structures belonged to the Soviet State. In 1991, an ordinance of the Supreme Soviet of the Russian Federation for the first time introduced different property forms and the

criteria for delimitating them.⁹¹ At present, Moscow is one of the few Russian regions where there is land still belonging to the federal state. This situation is preserved due to the special legal and political status of the city, being the capital of the Russian State.

Delimitation of state and municipal property was enacted by decree in March 1992.⁹² According to this decree, “the rights of state and municipal (public) ownership are vested in the respective state and municipal entities as a whole i.e. the Russian Federation and its constituent republics, regions, provinces etc. as well as municipal entities, but not the government or administrative bodies thereof.” Fundamental principles of the policy of the Moscow City government in the sphere of real estate envisage that land constituting state property of Moscow is considered to be in common joint ownership of the population in the capital.⁹³ Such state property does not include land transferred to the ownership of the Russian Federation⁹⁴ or transferred in ownership of other persons.

In the above connection, the city of Moscow faces an acute problem relating to the delimitation of the former single state property into federal, local and municipal forms. A 1993 ordinance of the Government of Moscow established the criteria for delimitating property in Moscow.⁹⁵ In 1995, the Moscow City Duma adopted an Ordinance that marked the beginning of the real process of delimitation of property on territory of the city.⁹⁶ It is the Complex for Economic Activity, Property, and Land Relations that is responsible for the delimitation of Moscow, forming part of municipal

⁹¹ Ordinance of the Supreme Soviet of the Russian Federation No 304 “ On Delimitation of State Property” dated 27 December 1991.

⁹² In accordance with Decree No 114 on ‘Regulations on Defining the Object Composition of Federal, State and Municipal Property and on Procedures to Register the Rights of Ownership’ dated 18 March 1992.

⁹³ Decree of the mayor of Moscow “On the conception of the Municipal Policy in the Sphere of Realty”.

⁹⁴ In accordance with the Federal law “On the Status of the Capital City”.

⁹⁵ Ordinance No 868 “ On Rules of Managing Realty in Moscow” dated September 1993 establishes criteria for delimitation of property in Moscow on the basis of the Law of the RF “On the Status of the Capital City of the RF”.

⁹⁶ Ordinance of the Moscow City Duma “ On the Municipal Property, of the City of Moscow” dated 15 February 1995.

property management plan. However, the criteria established by the legislative acts were considered by the federal government as biased, reducing the number of items in federal ownership too much. This has generated long arguments between the State Property Committee of the Russian Federation and the office of the Mayor of Moscow.

To resolve these issues, the federal government prepared a draft of the federal law “On Land”. The draft contains a number of innovations, making things cleaner as regards regulations of land relations. An attempt is being made to give a definition for the first time of the term “state property”, stipulating that bodies of state power which encourage this property must govern exclusively in the interests of the population. Furthermore, the draft introduces a new division of land into two main categories: public and private land. It also establishes a clear procedure for the delimitation of state land on the basis of agreement processes between the Russian Federation and its territories of self-government. The same law stipulates the differentiation of power bodies on the questions of preparation of the corresponding normative land registration and everyday management of land resources. Finally, the draft law establishes special rules of concluding transactions with land plots, taking into consideration public interests to the maximum possible degree.

The new laws seem promising on paper. The question however remains whether there will ever be an effective administration of the measures proposed. Until the new rules come into effect we do not expect any major progress in this field.

7.4.2 The Legal Framework on Land Privatization

Privatization legislation does not cover land. This is explicitly stated in the privatization law⁹⁷, and repeated in the 1994 privatization program. In March 1992, President Yeltsin allowed privatization of land in connection with privatization of the

⁹⁷ Article 26 of the Privatization Law.

enterprises that occupy the land in question. However, no detailed provisions or procedures were laid down in this decree.⁹⁸ Only three months later President Yeltsin adopted a new decree, this time outlining the procedures for purchasing land for commercial and industrial purposes in through the process of privatization.⁹⁹

Today, federal law allows the disposal of all important land rights, with the hope that by transferring them to certain types of private sector agency they will be used in an acceptable way. At the same time, certain rights are withheld in order to influence more directly the use to which other rights are put. Some rights can be transferred for a particular period of time only, or for a period during which certain conditions are met, whilst others can be disposed of in perpetuity. The sale of land is overseen by commissions with representatives of local administrations. Land plots are offered to foreign investors largely on a lease basis. The local administration has the right to conclude these deals with on behalf of the state. Disposal can occur at below market rate values and the original ownership can be in the name of the public authority alone or in the joint names of the public authority and another -often private- agency.

Notwithstanding the fact that President Yeltsin has issued additional decrees in July 1993 and in May 1994, further refining the privatization of land, very few such cases of privatization have actually taken place at the federal level to date. One reason is the relatively high cost of land. The main reason, however, is that the regulations are neither comprehensive nor transparent. This situation will continue until the Russian Duma passes the new Land Code currently under preparation. In the meantime, the provision of the new Civil Code dealing with private ownership will not become effective.

⁹⁸ Decree No 301 of the President of the Russian Federation.

⁹⁹ Decree No 631 of the President of the Russian Federation dated 14 June 1992.

7.4.3 Land Privatization in Moscow

According to law, the Moscow City government has the right to perform privatization of land belonging to the city. Moscow land belonging to the federal state is subject to the federal privatization laws. For pieces of land under the joint jurisdiction of local and federal government, all local practices need to be in conformity with federal legislation and in the case of conflict the federal law supersedes.

The process of land market development began in Moscow in 1991 with the creation of the Moscow Land Committee (Moskonzem) initially charged with the function of economic and legal regulation of land relations on the city's territory. These covered issues of land use, granting and withholdings of land, control over levying rent, etc. The principles of the Moscow land privatization program included the following provisions:¹⁰⁰

- a) Formalization of legal relations with respect to property shall not be accompanied by transfer of city land in private ownership until the Fundamental principles of Land Legislation of the City of Moscow are adopted;
- b) Origination and transfer of the right to ownership to any real estate located on Moscow land shall not imply the right of ownership to the land plot on which this property is located;
- c) Property of the city shall be preserved as a source of revenue for the state budget with the objective of ensuring normal functioning of the city complex and social protection for Muscovites.

¹⁰⁰ "Report of the Moscow Property Fund on state and municipal property in 1994" . May 1995. Moscow. Materials of the Moscow City Property Fund.

Given this framework, Moskomzem has enjoyed since 1993 the authority of holding tenders, granting rights to long-term leaseholds of land plots in Moscow.¹⁰¹ Originally realtor firms were also invited to hold such tenders. Starting late 1994, all tenders were to be held directly by Moskomzem. The first land tender took place in May 1993. Since then, several hundred land plots have been transferred to commercial structures on leasehold terms.

The procedure used is the following: Moskomzem puts together a list of lots to be tendered, defines the start price of each plot and by means of publication in mass media delivers that information to potential investors. The start price for land is determined on the basis of its location, the nature of its structure, the significance for the needs of the city as a whole, etc. Interested firms approach Moskomzem or an intermediary realtor firm and in order to participate in the tender, they advance a guarantee deposit equal to 10% of the start price to the account of an authorized realtor or Moskomzem. The firm also submits to the tender board the envelope, containing the highest acceptable price for leasehold rights. On the settlement date, all envelopes are opened and winners are determined for each lot. One meaningful consideration taken into account when identifying winner would be any extra commitments offered by the investors (charities, donations, bribes, etc.)

The early stages of land privatization in Moscow saw undervaluation of some land plots with final prices being 100 to 500 times higher than the start price. Since 1994 the cover ratio has rarely exceeded 10-15 percent levels. In order to increase commercialization of land transactions the association of Realty Market Participants, an institution of the Moscow Chamber of Commerce and Industry, has established regulations on the mechanism of option tenders.

¹⁰¹ According to decree of Mayor "On Introduction of Amendments and Additions to the Structure and Regulations of the Moscow Land Committee" dated 22 July 1993.

Lately, the cost of acquiring a lease on Moscow land has varied from a minimum of 300 thousand USD/ha to a maximum of USD 20.2 million/ha with an average of USD 5.6 million/ha.¹⁰² These figures do not cover any indirect costs incurred during negotiations with the local government. The level of such costs is difficult to assess. It is exactly this aspect of the process that increases the risk of acquiring land directly from the government. Foreign investors often prefer to pay a premium and acquire land leases in the secondary market. The secondary market is operated by local officials who retain control over Moscow land in order to sell their interests directly to private entities at much higher rates or to use the leasehold rights as their contribution to joint ventures with primarily foreign developers.

7.4.4 The Power of Politics and Land Privatization in Moscow

Land transfer law cannot be divorced from the historical circumstances of any country in the developing world. Easier land transfer laws could mean whittling away the protection afforded by law to certain groups or classes within the state, and/or making easier for non-nationals to purchase land, thus raising fears of landless nationals. These fears are difficult to ignore and, in the case of Moscow, act as a powerful counterweight to any development of simpler land transaction procedures.

As the operation of a private land market is discouraged the authority itself needs to ensure that it takes over many of the supply side functions of the market. If it fails to do so, and this seems to be a particular danger when planning and land banking are carried out by the same public agency, again an inflation in land values is probable as the supply of land dries up. Moreover, although initial rents may reflect market values, local authorities find it difficult to keep subsequent revisions in line, especially if ground rents are adjusted irregularly. With the possible exception of Sweden, no countries examined

¹⁰² Base Values of the Moscow market for land in 1996 according to the data of “Economics and Life” “*Ekonomika I Zhisn*” newspaper 1995-1996.

have evolved a system revising land rents that adequately maintain the government's economic equity in the property after its development.

The City of Moscow has made little progress towards the privatization of land rights, despite the fact that property privatization is a much simpler process for countries such as Russia facing no restitution problems. The uncertainty over the right of Russians and foreigners to own land under a building continues to make privatization a risky vehicle for land acquisition. The process of privatization requires the existence of clearly defined private property rights. Although the Constitution of the Russian Federation proclaims the right of private ownership to land and official land sales by local authorities have started in some regions, most of the vacant land in Moscow remains in the hands of the state, federal or local.

The sale of land is held back not only by the absence of an elaborate legal basis but also by the apprehensiveness on the part of the authorities that they are going to lose control over the use of land plots. The power to make decisions on land is an important dimension of politics, and is not to be given up lightly. Any freeing up of power in the interest of speedier land development represents a shift in political power from the public to the private sector, a shift from officials to land developers. Thus, there may be perfectly rational calculations behind a resistance to speed up decision making with respect to land issues.

7.5 Land Registration and Information System

The development of a sound land market requires the establishment of a comprehensive and efficient system of land information and registration. In Russia, there is currently a dual system of land information and registration, a federal and a local one. The first piece of federal legislation regarding land registration appeared in December 1993. At that time, the president of the Russian Federation imposed the function of

registration and formalization of documents on the rights to land plots and the real estate tied to them on the Land Resources and Development Committee of the Russian Federation and on its territorial organs.¹⁰³ Later, provisions were added to the Civil Code according to which, “the right of ownership and other rights to things in relation to real estate, limitation of those rights, their arising, transfer or termination, are subject to state registration by justice institutions in the single State Registry”.¹⁰⁴

At the local level, the Moscow City Government has taken major steps towards the development of land registration procedures and a land information system. Already 18 months before the first federal law was introduced, holders of ownership rights to existing land plots in Moscow were obliged to formalize their rights according to specific documents.¹⁰⁵ Since then, the responsibility of keeping the state register of federal, state and municipal property on the territory or in ownership of the Moscow City has remained in the auspices of the Complex for Economic Policy, Property and Land Relations. The same government body is also charged with the task of inventorying state property and of keeping the state cadaster of municipal land in Moscow City.

To this end, the Complex has enacted a uniform system of land rights registration in Moscow. This system is a constituent part of the State Land Cadaster of the Russian Federation. It contains the necessary information about the boundaries of Moscow land plots, the legal regime of those land plots, the distribution by right-holders and the legal regime of the real estate situated on the land plots. It also includes information on contractual and inheritance rights to the land plots and to the real estate located on the respective land plot. The land information system is integrated into the Moscow Geographic Information System.

¹⁰³ Edict of the President of the Russian Federation “On the State Land Cadaster and Registration of Documents Certifying Rights too Real Estate” dated 11 December 1993.

¹⁰⁴ Article 131 of the Civil Code of Russia.

¹⁰⁵ Documents depicted by Decree of the Deputy of the Mayor of Moscow No 264 “On Rules of Keeping Record of Lands and Registration of Rights to Land Plots” dated 28 May 1992.

The document that guarantees the right of ownership, inheritable possession for life, perpetual, temporary use or lease of land plots is the Land Book of Moscow. This document consists of the titles to land plots and is kept by the Moscow Land Committee (Moskomzem). In Moscow, most individuals and even many of the legal entities do not conform to the registration requirements. For this reason, when taking a lease on land, the title to it should always be investigated even when the lessor is the Moscow City Government. Those in possession of rights to a land plot or rights associated with the use of a land plot are eligible to receive the relevant certificate of their title to the land plot. The quality of a title to a land plot is something that can be directly negotiated with the local government at a cost. Any concerns regarding title on a land plot may now be allayed by obtaining title insurance that is now available from the government.

7.7 Summary and Conclusions

One of the most important obstacles to new office development in Moscow is the absence of an efficient land market for commercial use. The current system of land acquisition is characterized by a number of inefficiencies:

- 1) At the administrative level, there is still not a clear separation of responsibility for land policy between the local and federal governments, causing vagueness, arbitrariness, and dispute among national and sub-national administration. Furthermore, while conflict resolution is well determined for the areas of Federal jurisdiction and areas beyond the jurisdiction of the Russian Federation, no methods are set forth for land issues falling under the joint jurisdiction of the two levels of government.
- 2) At the legislative level, there is clearly a need for the establishment of a sound legal framework to govern land disposal and land relations. One of the most important pieces of legislation related to commercial real estate development, zoning is still

missing. Laws are not only in conflict at the federal and the local levels, but are also continuously amended further reducing security of land tenure, the most important condition in raising development finance.

- 3) At the political level, there is still the need for political will to guide the design of an effective policy on land issues, and to guarantee the policy's implementation. In Moscow, what we often observe is practice being in conflict with the applicable rules. We therefore see foreign investors, being a major source of new office development in Moscow being discouraged by a system that fails to (a) provide the necessary framework on land rights and (b) exercise the proposed by the law principles of equal treatment of national and international developers. In effect what we have is a system where all control over policy and implementation rests with the local officials who in turn chose to use it at their discretion, in order to extract personal benefits.

Chapter 8

Financing Commercial Development in Moscow

The most complex problem which local builders face in Moscow is the financing of projects, as it is rather unlikely that they can secure large-scale investments from Russian banks. The problem of shortage in sources of financing was addressed in the early days of the Moscow real estate market with future tenants providing long periods of lease prepayments.¹⁰⁶ Later, the city government introduced several policies to support development including: (a) the use of city property as collateral in order to raise credit in the commercial banking sector and the establishment of the Moscow Land Bank¹⁰⁷, (b) the contribution of city property as an asset in joint stock companies seeking co-operation with the private, domestic and/or foreign construction sector, and (c) the continuous promotion of commercial real estate projects in the international market of real estate investors.

The purpose of this chapter is to identify any inefficiencies caused by the local government in the Moscow market for real estate finance. In doing so, we will examine the impact of the Moscow City Government on the legal framework for real estate finance, on the banking sector, and on investment promotion for commercial real estate development. The reader will first be presented with an overview on the conditions in the market for office development financing. After discussing the legal framework on real estate finance, we will look at the credit and equity markets for investment capital in real estate. Finally, we will concentrate on the role of the Moscow City Government in financing new office development.

¹⁰⁶ In the case of the “Perestroika” joint venture, the project came off the ground with a 10-year lease prepayment. For more information on lease prepayments refer to Chapter 4.

¹⁰⁷ Later, this was expanded to include international markets of credit financing as a result of the introduction of International Standards for Mortgage Lending.

8.1 Main Sources of Real Estate Finance

During the first half of the 1990s the Moscow market for commercial real estate was characterized by:

- Limited debt market
- No investment market
- Limited expertise at all levels
- Little if any supporting service industry (consultants, valuers etc.)
- Lack of market knowledge
- Substantial title problems
- Poorly defined and enforced regulatory framework
- Often insurmountable bureaucracy

To succeed in this market required a deep pocket. Few of the entrepreneurial developers, attracted by the promising returns of the market, were sufficiently capitalized to survive. In many cases throughout Moscow, developers commenced projects without the necessary funding to see their projects through from start to finish. Consequently, many developments remained unfinished for some time, purely because of funding problems, despite the strong demand for office accommodation persisting over a typical development cycle.

Poorly capitalized developers quickly lost their credibility in the market. At the same time, well-capitalized contractors took on the development role, using their credibility as major multinational corporations, to set up joint ventures with the local authorities. These joint ventures developed some of the best city center sites. Although this resulted in a number of successful projects, it has also given rise to some of the

greatest scandals. Over the past 7 years, the market has evolved into a contractor-led market. Throughout this period, developers have relied on four sources of funds: their own resources, conventional bank loans, rental prepayments, and city participation. The combination of these elements has greatly influenced the success of each project.

8.2 The Legal Framework on Financing

The availability of financing for office development relies heavily on the degree of progress made in establishing an efficient legal, institutional and regulatory framework. In the following section we will look at the current regulations regarding financing commercial real estate development in Moscow. We will first examine the importance of laws on security interests. Then we will analyze the effect of property rights, the leasehold system, real estate valuation and rights registration in Moscow, on the system of financing office development. Finally, the section will close with a discussion on the effectiveness of the legal regime on real estate financing in Moscow.

8.2.1 Laws on Security Interests

There are two main laws governing the creation of security interests in a real estate market: the Law on Collateral and the Law on Mortgage. In Moscow, the Law on Collateral was introduced in 1992 and provides a measure of coverage regarding secured interests on real estate or personal property. It permits the creation of security interests over real estate, the only restriction being that to create a secured interest over property, property rights must be transferable to another person or entity under Russia Law.

A Law on Mortgage was also proposed, but did not pass because of potential political opposition to the principle of private property.¹⁰⁸ The bill was vetoed by the President on July 28 1997, for what were perceived as inconsistencies with the Civil Code and other existing legislation.¹⁰⁹ In all courts in Moscow, immense ideological resistance remains against tolerating some degree, let alone dominance of private property. At best, private property is placed in the same legal category as public property.

Although some foreign experts¹¹⁰ insist that, “there is coming the legal framework to protect secured interests and foreclosure”, current Moscow legislation has a long way to go before it reaches standards acceptable by western credit practices.

8.2.2 Property Rights

As we saw earlier in Chapter 7, political reasons have caused land rights (ownership as well as land-use rights) to be continuously redefined. The Moscow City Government has recently recognized that involvement of land in market relations stimulates business and investment activities, puts barriers to illegal land dealings and, most importantly, brings about significant revenue to the city budget. The Moscow City Government has therefore introduced a legalized market for land in the city in the form of attaching market features to the right of land leasehold.¹¹¹ This decision enables the owner of a leasehold right to realize his right in the secondary land market, i.e. the right to lease may be sold, used as a contribution to the charter capital of a joint stock

¹⁰⁸ According to Ivan Grachev, Vice Chairman of the Duma committee on Property, Privatization, and Economic Activity as expressed in the article “Russia’s Mortgage Application: Denied” in *the Russian Realtor/Business in Russia* magazine, September-October 1996 issue.

¹⁰⁹ Although the Russian Federation has taken measures to enable foreigners to buy land, in Moscow, there are still restrictions on private property rights on land.

¹¹⁰ According to Michel Camdessus, Executive Director of the IMF, as expressed in the article “Real Reforms Required”, of the *Russian Realtor/Business in Russia* magazine, September-October 1996 issue.

¹¹¹ Decree of the Mayor of Moscow No 254 dated May 24 1995.

company, pledged as collateral, or even granted as a gift. In effect, what the Moscow City Government tried to do is provide a substitute to the securitization of freehold by allowing collateralization of leasehold rights.

In practice, as of today only a primary market for land plots has functioned in Moscow. A secondary-type market operates only to the extent that government officials, having connections and access to such rights, resell them in the open market at a premium. Other secondary market activity is non-existent because of the local government exercising:

- a) Regulation over transfer and use rights on leaseholds;
- b) Poor valuation techniques within the local administration and regulation over property valuation;
- c) Poor registration procedures on ownership, use, and security interests over property, making it very expensive to research for other liens.

8.2.3 The Leasehold System

Under conditions of an efficient system of leasehold rights, a security interest may be created over the use of real property. This assumes that lease rights are clearly defined, transferable and carry no specific restrictions.

In Moscow, inflexible and doctrinaire attitudes held by those responsible for the administration of the leasehold system have caused it to be unpopular amongst developers. The sale of land under a formal system of public leasehold allows the local authority to impose restrictive covenants and to regulate the use of property rights, assigning specific duties to the land-users. The terms of the leasehold can be negotiated with the responsible public officials. This makes the transferability and collateralization of lease rights even more difficult since terms and conditions of leaseholds vary

tremendously. Under these schemes, creating standard procedures for real estate financing is impossible, making development funding a very costly and time-consuming process for banks.

8.2.4 Property Valuation

Property valuation lies in the heart of real estate financing. The creation of a security interest over real property depends on the outcome of a property valuation exercise. In Moscow, the local government has restricted the access to reliable sources of property valuation in a number of ways:

- a. By the government's political resistance to property privatization. This, combined with the fact that there are so few other sources of commercial transactions, hence so few leases or sales established on a competitive basis, means that there are virtually no benchmarks. The small portion of real estate that has moved into private ownership prevents the widespread use of privately set benchmarks in prices or leasing practices. In addition, the lack of alternative sources for commercial real estate acquisition protects local administration from competitive pressures on valuation practices.
- b. By the government's intention to regulate and monitor property valuation practices within the city of Moscow. In fear of a leasehold privatization of property at prices that are "too low", the Moscow government officially admitted the need for a state institution for valuation of property. According to this decision, government employees are the persons who must perform valuations of mortgaged property. Moreover, the local government will regulate the activity of all private valuers.

(Unfortunately, until these days, due to the absence of skilled human capital and the corresponding infrastructure (qualified appraisers, zoning techniques, title verification and registration procedures) the ability of local officials to perform real estate valuations has been extremely limited.¹¹² Consequently, the early stages of tender activities saw “undervaluation” of land plots. For this reason, the government decided to allow the use of expert opinions in determining the market value of non-dwelling premises. Such services may only be provided by organizations licensed to perform activities related to real estate valuation.¹¹³)

c. Access to reliable property valuations is further restricted by the differentiation in practices concerning land versus buildings. This makes the process of valuation even more complicated as there are different methods applied in each case, while responsibilities for each asset type is allocated to different administrative bodies. In general, when land is pledged as collateral for bank loans the “normative price of land” is introduced.

In summary, restrictive conditions on the level of open-market transactions in real estate, coupled with limited access to independent opinions regarding property valuation, considerably increase risks of financing commercial developments in Moscow. Professionals in the Moscow real estate market go as far as to argue that further distortions are often caused by those in possession of the best valuation skills, e.g. international consultants and leasing agents. These people are believed to engage in “opportunistic behavior” and artificially drive rents up with the ultimate goal of maximizing their own revenues (a commission-based compensation event). However, there is no evidence presented to date to support this argument.

¹¹² The Economic Development Institute of the World Bank has conducted numerous training programs to address this critical problem.

¹¹³ Members of the Association of Independent Valuers

8.2.5 Property Rights Registration

Secured interests must be registered if property which can be registered is involved. A major weakness of the Russian system governing secured interests is the system of registration. Experts in the Moscow real estate market often refer to the underdeveloped real estate registration system as the biggest obstacle to foreign direct investment in Moscow's real estate.¹¹⁴

A system of registration of land ownership rights and of land transactions is currently under development in the Russian Federation. Existing legislation provides for registration of legal title and other transactions, including mortgage on a land plot or on other real property, in the district where the property is located. The procedure for title registration varies according to the type of property. Internationally acceptable titles to projects and their lots are granted only after construction completion, which makes it impossible to get the usual insurance coverage for projects under construction.

On 30 January 1998, a law came into force that intended to provide a unified registration system.¹¹⁵ Although the unified registration system is currently being implemented, the agencies that were carrying out registration tasks prior to the entry into force of the registration law continue to do so. Land rights, rights to buildings and occupancy rights are each registered with a different agency. This makes obtaining complete and reliable information a burdensome and time-consuming exercise and steps are being taken to streamline the process.

The incomplete framework on property rights registration adds to the cost of creating a security interest in Moscow real estate. The city is moving towards a uniform system of land title and land transaction registration. Progress in this field has been in general well-received by foreign entities involved in the real estate market in Moscow.

¹¹⁴ According to William Lane of Noble Gibbons Real Estate Consultants as expressed in Aleksandr V. Kharitonov and Yekaterina Kravchenko's article "Buildings Socialism" published in the *Russian Realtor/Business in Russia* magazine September-October 1996 issue.

¹¹⁵ Refer to Chapter 7 for more details on the system of land rights registration.

However, there remain various practical barriers such as poor communication infrastructure, arbitrariness, and lack of disclosure by local authorities. Another important shortfall is that the government does not guarantee against losses due to inaccuracies or errors in the registered data and it will not do for a while, considering the chronic lack of governmental funds.¹¹⁶ Notwithstanding, title insurance although expensive, is now available. Subject to a good title and a lease that can be properly negotiated, a secured interest in land can be currently obtained in Moscow.

8.2.6 Effectiveness of the Legal Regime on Financing

Russian legislation governing secured interests provides substantial freedom for the parties to negotiate contractual terms for a particular transaction. This has often favored developers at the expense of lending institutions and the government.¹¹⁷ Perhaps the most important pitfall in credit financing for commercial development is the inability to foreclose on properties. In general, if a document creating a secured interest is correctly drafted, executed and registered under Russian law, that secured interest will take priority over the subsequent secured interests. However, since there are few examples so far of the creation and enforcement of secured interests in Moscow, the effectiveness of the existing legal regime is unclear. The legal framework to protect secured interests and foreclosure is currently being formulated. In the meantime, legal transaction costs for participants wishing to enforce their rights can be very high.

Moscow has a lot to learn from more mature real estate markets previously faced with similar problems, such as those in the Czech Republic, Poland and Hungary. In the Czech Republic, good title records, a fairly easy (therefore less costly) process of

¹¹⁶ “Status of Reform in the Russian Real Estate Market” by Adrian Moore and Mario de Echevarria of Baker & McKenzie, *Estate News Moscow Supplement*, February 1998.

¹¹⁷In one case a developer had borrowed and had to repay the loan when the project was completed; the project was completed, but the borrower did not announce completion, delaying loan repayment, collecting income in the meantime while interest on loan was tax deductible.

determining ownership and encumbrances, nominal fees for registering acquisitions and mortgages in the land records, and a relatively good framework for leasing real estate, has allowed the development of a fairly competitive market for commercial real estate finance. Furthermore, a good legal framework on mortgage financing¹¹⁸, providing liens to be registered against real estate, bankruptcy laws giving special priorities to lien creditors, and imposing no restrictions on granting mortgage loans by foreign lenders, has made real estate loans to be very common. An additional benefit of the Czech system is that revenue from mortgage bonds is currently free from income tax. Due to these reforms, there are six mortgage banks active today in the Czech market offering up to 80% debt on a project with a 20% private equity commitment. The group includes some of the largest international financial institutions, such as the German Bayerische Vereinsbank.

In Poland and Hungary similarly, new laws governing property finance, tenure and licensing of agents that have recently come into effect, have contributed to the modernization of their real estate markets. The launch of the USD 60 million Pioneer Polish Real Estate Fund in Spring 1997, with the contribution of Pioneer Real Estate Corporate of Delaware, is clear evidence of the changing attitudes of investors towards markets with a well-developed legal and institutional environment for real estate finance.

8.3 The Banking Sector

The primary problem associated with credit financing for office development is presenting acceptable guarantees. Banks will not accept land as collateral, as the ownership of land in Moscow is still restricted. However, they may accept future income from existing lease contracts as loan security. This gives larger developers a distinct

¹¹⁸ Information on the legal framework for Real Estate finance in the Czech Republic comes from reports prepared by the Central and Eastern European Real Estate Practice Group of International legal advisors Weil, Gotshal & Manges LLP.

advantage over new entrants in the market for office development: well-established developers can secure funding on the income generated from existing leases on other properties they have already developed in the city. In fact, some of these developers have been able to secure loans from western banks at preferential interest rates.

Unlike equity financing, where it is common to have domestic/foreign joint ventures, in credit financing, foreign and Russian investments hardly mix. A foreign bank would support a foreign real estate project in Russia, but would rarely service loans for local developers. Similarly, local banks are only likely to undertake minor retail banking for international developers. In practice, both foreign and domestic institutions share one common feature: the low level of cumulative credit so far committed to the Moscow real estate market.

In the next three sections, we will discuss the conditions in the foreign, local, and mortgage banking sectors in Moscow separately. We will then present the reader with the prospects for credit financing of office development in Moscow.

8.3.1 Foreign Banks and Institutions

During the past decade, the international market of real estate finance has been characterized by:

- borrowers defaulting on loans;
- lenders overburdened with non-performing loans with loan turnover greatly reduced;
- substantial pressure on lenders to reduce exposure to the property market;
- many international lenders closing their property books and exiting the market altogether. This is particularly true for certain Japanese and American banks which have experienced considerable problems in their own domestic markets.

The combination of these factors has urged the development of new sources of real estate financing. The securitization of real estate assets has proven to be one of the most successful methods of attracting investment into property development. By structuring new financial vehicles, such as Commercial Mortgage Backed Securities (CMBS), developers managed to introduce liquidity into real estate, an investment traditionally classified as one of the least liquid. The securitization of real estate has significantly increased the availability of credit finance for commercial development throughout the international capital markets.

The Moscow office market has yet to benefit from these positive developments in the international credit markets as the local government continues to a) regulate the establishment and operation of foreign banks in the city, and b) oppose the development of clear property rights and private ownership over real estate.

Regulations in Moscow discourage western credit by imposing special requirements and limitations on foreign-owned banks and their branches. First, the Central Bank determines an annual limit on foreign participation in the banking system.¹¹⁹ Since 1993, this limit has been set at 12%. Second, there is a higher minimum capital requirement for foreign-owned banks and branches thereof. Furthermore, while in the past procedures for setting-up a foreign-owned bank in Moscow were simple, these policies have recently been reverted, so that, today, foreign banks can no longer receive a general banking license from the Russian Central Bank.¹²⁰

Until the local government is convinced of the need for private ownership rights on land and property, most foreign banks, accustomed to functioning in well-developed tenure systems, will continue to resist financing commercial real estate projects in Moscow. In such an unfavorable environment and given the competitive conditions in the international markets for real estate finance, foreign creditors will need to see more

¹¹⁹ Pursuant to Russia Central Bank Letter No 14 of 8 April 1993.

¹²⁰ Under a moratorium imposed on 15 November 1994.

projects completed with credit financing before they decide to expand their activities in the Moscow office market.

8.3.2 Local Banks

Russian banking circles, have become impatient and frustrated with many developers who borrowed beyond their means and “*a lot of time has passed since the first loans to developers, but they had yet to reap the profits they had been counting on*”¹²¹. Local commercial banks have become particularly risk-averse as far as financing commercial real estate is concerned, also due to the high profit tax (45%) imposed on their activities. A presidential decree in 1994 instructed the government to draft tax incentives for commercial banks to provide loans for the construction and purchase of real estate. So far these incentives have not been enough to promote real estate lending while banks made most of their money in the Government bonds market. Although these incentives may in the future improve to a certain extent access to credit for small entrepreneurs, uncertainty regarding property rights -just like in the case of foreign banks- will probably continue to be the major obstacle to local credit financing of large-scale office development in Moscow.

8.3.3 Specialized Real Estate Credit Institutions

Traditionally, due to the peculiarities of real estate as a credit market, specialized institutions are set up to structure financing for development. In Moscow, the establishment of specialized mortgage banks has been undermined by the lack of funds, expertise, and of the appropriate legislation. Although there is a number of Russian

¹²¹ According to the proceeds of the International Conference on Russian Real Estate organized by the British Adam Smith Institute on February 199, published in Aleksei Shchukin’s article “Network Development” included in the Russian Realtor/Business in Russia magazine, September-October 1996 issue.

banks calling themselves mortgage banks, very few (if any) actual mortgage loans have been made until today. To improve conditions, Mosbisnesbank approved in 1994 the creation of a Center for Mortgage Credit, but no disbursements had been made as of March 1995. At the same time, the Moscow Land Investment Bank was licensed to evaluate property and arrange rental and other real estate transactions. However, one year later, they were still preoccupied with training personnel. Today, in the absence of mortgage law, most Russian “mortgage banks” provide financing for a period of three to four months. This is mainly short-term construction finance for the importation of foreign building materials.

8.3.4 Prospects for Credit Financing of Office Development in Moscow

Alternative solutions to the shortage of “cheap” financing have been suggested at times, such as the reduction of the reserve requirement ratio of commercial banks to the Central Bank. In 1996, the decision to reduce the ratio led to a strong consolidation in the banking sector. From approximately 2,500 financial institutions (credit offices etc.) operating in Moscow in 1996, many of them went bankrupt, after having performed major lending activities, including some real estate deals. To protect the viability of the surviving institutions, the ratio was later raised back to a higher level. Following the recent crisis in the banking sector in Moscow, not only did the policy fail to induce lending, but instead, institutions became even more reluctant to long-term lending for commercial development in a market with a track record of only six to seven years.

In summary, banks, the primary sources of credit finance, are still reluctant to lend to the real estate sector in Moscow. On one hand, domestic banks lack the necessary expertise to perform the required analyses and valuations. On the other, foreign banks, possessing such skills, are still discouraged by an unreliable legal framework on property rights and security interests. Unfavorable conditions on real estate credit financing are

further reinforced by the government's restrictive policy on banking activities. In the interim, some banks have provided mortgage loans at accessible interest rates, notwithstanding the difficulties of enforcing mortgages. Developers have used completed projects, as collateral to finance new projects and it is now possible to pledge an unfinished construction. In absence of a law on mortgage, of clear and transferable property rights, and of market benchmarks for property valuation, financial institutions, whether foreign, local or real estate-specific will continue to keep a distance from developers.

In the future, it is rather unlikely that such measures will significantly contribute to any improvement in commercial development financing in Moscow, so long as there is an absence of a reliable legal framework. Further progress is expected in the coming years, as a mortgage credit agency based on the American "Fanny Mae" only lacks adequate funding to be up and running. This agency would buy from banks mortgage portfolios meeting certain requirements, thereby increasing professional standards and liquidity in the market. In addition, the final passage into law of the mortgage law is hoped to allow mortgage credits to circulate as a tradable security. Given the effect of the recent financial crisis on the banking and other financial institutions, as well as on the demand for commercial real estate, very little demand for financing is expected to arise in the next few years. In the meantime, we should expect some of the developers renegotiating their loans, or defaulting properties falling into the hands of the creditors. As conditions of weak demand are likely to persist well into 1999, the local government may well take advantage of the time to introduce all necessary rules and mechanisms for the efficient operation of a real estate credit market.

8.4 The Future Role of the EBRD (European Bank for Reconstruction and Development)

One of the international financial institutions expected to play a catalytic role in the development of an efficient real estate market in Moscow is the European Bank for Reconstruction and Development (EBRD). The EBRD, established in 1991 to foster the transition towards free-market economies in Central and Eastern Europe and to promote private-sector initiative in the region, is today the only financial institution with a dedicated sector team covering the property sector.

It was four years ago when the Bank's Board of Directors approved a strategy focusing on the property sector. The decision was based on the idea that "an efficient, fully functional property sector is an essential ingredient in the development and operation of a competitive, market-oriented economy"¹²². By financing property development the Bank aims at promoting transition through:

- a. Supporting the discipline of evaluating projects based on their economic fundamentals and profit potential (this refers equally to the lender's credit evaluation process and investment decisions of equity partners);
- b. Promoting competition in the region: the development of modern commercial space improves the efficiency with which resources are utilized, stimulates innovation and in the long run, lowers the overall "cost" of transactions;
- c. Expanding private ownership being the result of privately financed development. Private ownership enhances market-oriented principles and is in itself part of the transition objective;

¹²² "Property and Transition", article by Marc Mogull Director of Property and Tourism, EBRD published in *Estate News magazine, Financial Supplement*, Summer 1997 issue.

- d. Creating and reforming governmental institutions, policies and practices. As the largest investor in the region, the Bank has easier access to policy makers than other investors; The EBRD can therefore promote improvements in the functioning of regulatory entities, in transparency, and government policy design;
- e. Supporting good corporate governance and business conduct. Through its projects, the Bank aims at providing examples of good business practices that also need to be profitable business practices.¹²³ Property projects can contribute directly to improving the skills required for well-functioning markets. These include management, procurement, marketing, financial and banking skills, all necessary for the transition to market-oriented economies.

In this framework, the EBRD acts not only as a lender, but also as an equity participant, investing sizable sums in shares. Unlike the case of city government participation in projects throughout the region, the Bank is driven by sound banking principles, so that its investments are repaid with reasonable returns. According to their policy, two preconditions must be satisfied for the Bank to finance a project: (a) the Bank must be additional and second, and (b) the project must have a measurable impact on transition.

In terms of actual activity of the Bank in commercial real estate development, most of the projects financed to date by the EBRD are found in countries of Central Europe. Among others, the Bank has financed a 20,000 square meter business center in Warsaw (Atrium Business Center) and has put together a 22.4 million ECU financing package for the largest private sector office development in the region, the Warsaw Financial Center. EBRD is considered the leader of syndicated loans for the purpose real estate development in the region.

¹²³ The EBRD calls this the “demonstration impact”.

With markets changing, the nature and geographic focus of the Bank's project work changes also. To this direction, the Bank has recently provided equity financing for the rehabilitation of city center office space in St. Petersburg (8.4 million ECU) as well as a 19.4 million ECU loan for the construction of retail facilities in Moscow. As the need for assistance in the transition process in Central Europe recedes, the EBRD is gradually shifting its focus towards profitable projects in Eastern Europe. The recent financial crisis provides an opportunity for the EBRD to play a major role in reforming the legal framework and financing practices in Moscow's fledgling real estate market.

8.5 Equity Financing

Equity is becoming an increasingly important source of development financing worldwide. The securitization of real estate assets has attracted a large inflow of investment capital in the international real estate markets. Despite these recent developments, there is still a shortage of equity investment¹²⁴ in Moscow's commercial real estate market due to:

- Political considerations
- Domestic competition for foreign investment
- International competition for development capital

During the first five years of political transformation, most of the shortage in foreign investment for development was attributed to the political climate in Russia, generally perceived by westerners as "unstable". In the past few years, following President Yeltsin's re-election, thoughts of political instability have receded to the background of most investor's preoccupations and Moscow has started to gain access to foreign equity sources. Nonetheless, the benefits of these changing attitudes and

¹²⁴ By equity financing here we refer to almost exclusively foreign investment.

consequent capital inflow failed to accrue for the real estate sector as yields in Russia's short-term federal bond and securities market (although significantly depressed relative to the highs of the mid-1997) continued to be more attractive to general emerging funds than real estate.

Office development in Moscow not only has to compete for equity investment domestically, but also needs to be competitive internationally, vis a vis investment opportunities offered at other strong real estate markets. International competition for development capital is one of the reasons why, from a long list of international real estate funds considering investing in Moscow, only a few have actually proceeded with major activities. Many of these investors have often found favorable tax and legal regimes in other emerging/transitional economies. This is primarily true for pension fund-financed groups, who are particularly tax sensitive investors, who have often been offered preferential terms in other real estate markets in Central and Eastern Europe. Foreign equity is also having a hard time investing in Moscow commercial real estate development due to another reason: as most potential investors are public companies with heavy disclosure requirements who are finding it difficult to justify "indirect" costs in their accounts. One way of going around this problem is by passing most of these costs to the contractor.

Despite the tax and legal difficulties, a number of international funds have sought to either develop directly, or for the first time, actually buy standing investments in Moscow in the past 2 years. Among the first ones to enter the market is the Regent Pacific Group of Hong Kong. By early 1998, the group had raised the first dedicated property fund for Russian commercial property, the Regent Russian Real Estate Fund, as a follow on to their highly successful Russian equity and loan funds. The fund was expected to make a number of commercial property acquisitions in Moscow within

1998.¹²⁵ Moreover, many of the major US real estate funds, such as those of Credit Swiss First Boston and Apollo, were also been closely studying the Moscow office market and are expected to make significant moves in 1998. The newly-established CEENIS fund was one of the first American funds to be convinced that investing in the region “makes for good business” as they could “manage 100% capitalization -equity and debt- and reinvest the returns”.¹²⁶

To date, most equity in office development has come from developers and contractors. With investment risk being very high, most developers counted on getting their money back either out of cash flow or out of advanced and/or quick sales. The first years of development saw most of new projects being financed with 3 to 4 year lease prepayments. With the terminal value of the building being excluded from the calculation of investment returns and with an investment horizon not longer than 10 years, commercial real estate projects were usually funded by construction companies themselves. Lately, given the high lease rates relative to construction costs, we have seen some new projects underway being financed by future users, primarily Russian banks and multinationals that have gone through their expansion stage and require premises of a size that justify the development of an owner-occupied building. These are buildings of 2,000 to 5,000 square meters of prime quality office space used are regional headquarters, back office operations of IT companies, etc. No significant investment equity has so far been committed in Moscow’s office market. Despite the protection of investment from risk and the favorable conditions in the international markets for development capital, there are only few exceptions of foreign investors active in office development in Moscow.. In the near future, we do not expect any significant equity investment by local or foreign parties. Given the recent crisis, most developers are now slowing down the construction

¹²⁵ According to Timothy Fenwich, European Director of Jones Lang Wootton Moscow as expressed in the article “International Institutional Investment in Moscow Real Estate: Will 1998 Be the Year?”, Estate News Magazine, Moscow Supplement, February 1998.

¹²⁶ As Andrew Stear, director of CEENIS development, stated during an interview at MIPIM 1996.

pace of projects underway. Most of these developments are financed with private equity much of which is already locked in the project. Although the latest conditions are not perceived as a real estate crisis, it is possible that any confidence of foreign equity investors in the Moscow real estate market will take long to be restored. Perhaps one of the benefits of the recent financial crisis to the real estate sector may be considered the fact that the investment market is likely to experience some rationalization. As short-term government bonds are no longer attractive to investors, the real estate sector, driven by sound market fundamentals could pick up some of the investment activity. In the meantime, we may see a few new developments coming on the market with the assistance of different sources of local equity, the legitimacy of which is questionable.

8.6 The Role of the Moscow City Government

Having examined the equity side of real estate finance we will now shift our focus to examine the role of the Moscow City Government in financing office development in Moscow.

The lack of financing for development was addressed by several policies introduced by the Moscow City Government. These policies stem from the power of the Moscow City Government to hold a superior interest in all city property. The argument for public local agencies in Moscow keeping ownership rights for themselves is that in this way they can:

- collateralize on the property to promote or guarantee investment activities within the city economy;
- restore confidence in the property market by undertaking some of the risks and uncertainties involved in certain kinds of development;
- enjoy future increases in land values through adjustments in land lease rates and return such gains later to the community.

In the following sections of the chapter we will assess the effectiveness of the local policies in stimulating development financing. We will first discuss the policy of mortgaging city property. We will then look at the outcome of joint ventures with City participation. Later we will present the city's methods of promoting foreign investment in commercial real estate. Finally, we will compare the effectiveness of public/private cooperation for the purpose of property development in the West and in Moscow.

8.6.1 Mortgaging City Property

The problem of attracting extra-budgetary sources of financing is still very acute in Moscow. As a federation member entity, Moscow has the right of independent foreign economic activities. Within the limitations imposed by the Russian Constitution, the city can pass municipal laws and bylaws to improve the investment climate. To this end, the Moscow government passed a decree in 1995¹²⁷, giving extra guarantees to investors by providing credit deals with mortgages on government-owned real estate in the city.¹²⁸

The use of city-owned property as a guarantee for activities carried out by local investment corporations, or as an object against which mortgage financing is raised in the domestic and international capital markets¹²⁹, is part of a strong tradition of extensive government involvement in economic activity at every level. It is therefore argued (mostly by local public officials) that this tradition, which predates the Soviet era, leads to an expectation on the part of officials and the citizens alike, that the government will continue to actively intervene in business operations and economic development.

¹²⁷ "On Mortgage Crediting in Moscow".

¹²⁸ New forms of guarantee are being set up for Western investors, related to leaving deposits with foreign banks through the State Investment Corporation (GOSINKOR). The GOSINKOR objective is to activate state investment processes, beginning by looking for foreign partners and ending by ensuring their investments against political risks. The guarantee of GOSINKOR is represented by real estate with a value of USD 1 trillion, the corporation's authorized fund being USD 500 million, and 5,000 bn rubles.

¹²⁹ Moscow loan bonds guaranteed by government instruments.

To carry out these activities, the Moscow City Government created the Interdepartmental Commission of the Moscow Government on Mortgage Lending. As a mortgage object, the city property may be utilized (real estate and movable property), handed over to enterprises for economic use, as well as leased. For this purpose, a mortgage fund was formed on the basis of prefectures and department proposals. Bringing property into the fund list means that the asset is reserved for mortgage and any operation with it is absolutely prohibited. According to this method, and by introducing international standards for mortgage lending, the city aims at gaining access to the international capital markets.¹³⁰

The mechanism of mortgage lending was primarily set up to support foreign trade operations and profitable projects in the sphere of capital construction. It was also envisioned that these measures would support the development of investment processes and of the real estate market, as well as the replenishment of the city budget. As far as real estate is concerned, the goals have not been met as of yet. Instead of improving efficiency these policies have:

- a) Postponed property privatization and the establishment of clear property rights;
- b) Deprived the city economy from considerable income that would be raised during the privatization process;
- c) Misallocated city funds; Loans made by city officials are not screened according to the appropriate criteria as:
 - local officials lack the skills to perform reliable valuations

¹³⁰ Approximate evaluation shows possibility for the city to obtain yearly USD500 mn of external loans against a pledge of the state property in Moscow and hundreds bn of rubles through issuing and circulation of the mortgage municipal bonds. The world leading financial institutions have taken a principle decision on the work with the Moscow City Government as a first class borrower. These include the EBRD that has decided to grant the Moscow City Government a long-term credit of USD135 mn, agreements with “Nomura International “ and CSFB to issue in the western market securities of the Moscow City Government at the amount of USD400 mn.

- local officials are induced to act in a discretionary manner and grant credit according to personal criteria, and as
- the city's objective in granting such loans is job creation instead of return on investment.

The consequences of such practices are multiple. First, the policy has resulted in an increase in corruption incidents within the local government, as lending activities are particularly vulnerable to discretionary behavior even in “efficient” western markets. Also, it has introduced unfair competition in the Moscow financial market. Private credit institutions are unable to compete with the city government, granting public loans at prescribed and often favorable rates of interest to private entities who develop, use, occupy or exchange rights on land. Finally, such loans and guarantees often end up costing the public too much. By using public property to pursue socioeconomic policies, the risk of not collecting it properly or not being paid back escalates.

8.6.2 Joint Ventures with City Participation

As we saw earlier in this study, public authorities can influence the ownership and use of property rights by:

- creating and enforcing privately owned property rights;
- acquiring and using their own property rights;
- disposing of publicly-owned property rights to private ownership; and by
- including and deterring the use of established private property rights

Another method of city support to property development is the participation of the Moscow City Government in joint stock companies established for the realization of a specific investment project. Investment of the city's money or property is meant to serve as a guarantee of the project's success to potential investors. There are many ways in

which joint public and private ownership can be formed. In each case, at least some of the property rights are held communally, and the potential benefits are distributed according to some agreed formula.

In Moscow, the best example of a joint venture with city participation is the development of the Moscow International Business Center “Moscow City”. Moscow City has been the largest city effort towards the development of commercial, business and cultural co-operation with foreign countries. The project envisaged the construction of 2.5 million square meters of office complexes, stock and commodity exchanges, conference halls, shops and hotels in an area as large as 50 hectares, together with the creation of a new transport system. Total volume of investment was approximately USD 8-10 billion. To develop Moscow City, an international consortium, ‘Moscow Developer’ was created in May 1993, consisting of famous American and Japanese firms. Moscow City was expected to serve as an “anchor” for the development of long-term links across all modern businesses.

A more recent large-scale project with the Moscow City Government’s participation is the underground commercial-recreational center on the Manezh Square. Total floor area is 77 thousand square meters and total investment amounts to USD 350 million. For this purpose, a joint stock company was set up to oversee the construction of an underground cultural and business complex. Construction works began in February 1994, and the project was completed in September 1997. Since then the project has been completely leased up and is fully occupied. In Manezh Square, the Moscow City Government began construction independently, with the plan to attract investors into an already half-built project. For this purpose, a target credit of USD 56.5 million came from the state of Germany, with the city’s resources acting as seed capital.

Although the city government has been able to accommodate part of the demand for quality office space by initiating new development, the success of such projects has been largely questioned. Indeed, there is neither a track record of successful projects

completed according to such scheme, nor the justification for why local officials should be more capable of screening good projects and provide venture capital to real estate than the private sector. In reality, the city has no incentive to complete the projects. This often results in projects that are badly timed. An example of this is the above-described Moscow City project that took a very long time to complete and could no longer be properly marketed.¹³¹

8.6.3 Real Estate Investment Promotion

In order to promote investments in development and construction of commercial real estate, the Moscow City Government has taken the initiative and has pursued an intensive marketing strategy of specific real estate projects. In March 1995, the Moscow City Government participated for the first time in the most well-know real estate exhibition/conference worldwide, MIPIM, taking place every year in France, where they offered over 50 of the most important construction and renovation projects. Some of these are already completed or under construction. Amongst them, the most important is the above-mentioned Moscow City complex. Since then, the city continues to be an exhibitor every year, promoting new projects underway. Part of the investment incentive package includes the fore-mentioned protection of investment from risk, secured by guarantees from the Moscow City Government.

In addition, the city often organizes major events on its own territory, an example of which is REALTEX. Realtex is an international specialized exhibition and conference on “Investment, Construction and Real Estate” that took place for the first time at the end of May 1997, and was co-founded by the Moscow City Government and the Ministry for Construction of the Russian Federation. As a result of the city’s active participation in such trade fairs, several of the world’s largest companies have already made reservations

¹³¹ The Moscow-City project also gave rise to a major scandal involving embezzlement of funds. Subsequently, the top management was sent to exile and has only recently returned to Moscow.

on land plots for the construction of their local premises. In the interim, there are still a great number of real estate projects in Moscow of interest to potential investors.

8.6.4 The Effectiveness of Public/Private Partnerships in the West and in Moscow

In the western world, public/private partnerships in real estate development are becoming increasingly popular among developers and public officials. Their main functions include:

- a) sharing risks with the developer through land write-down and cash flow participation;
- b) participating in loan commitments and mortgages;
- c) sharing operating and capital costs;
- d) reducing administrative red tape; and
- e) providing favorable tax treatment

In most cases, these types of agreements take place because of the need of developers to secure approvals, or to work with a public agency on publicly owned land or a redevelopment area. They are made to protect developers from future changes in zoning and other regulations that affect development entitlements. In this context, public/private partnerships offer a feeling of certainty regarding the regulatory process, by clarifying most rights, requirements and procedures in advance. The benefits of these agreements are returned to the community in the form of special amenities, fees or exactions provided by the private party. Alternatively, developers may have to pay for major off-site infrastructure or to build freeway interchanges. The only negative aspect of such partnerships is perhaps that they usually take a long time to negotiate.

Public/private partnerships are also very popular in what are today perceived as “volatile political climates” a term often used when referring to Russia. In Moscow

however, due to the inefficiency of the local administration, the benefits of such agreements to the community fail to accrue. The situation of the city being the primary developer as well as regulator leads directly to strong conflicts of interest including favoritism to some “friendly” developers. The stream of personal benefits city officials collect clearly plays a dominant role in perpetuating non-commercial management. City officials personally benefit from their control over real estate allocation, both in terms of money and political influence.

The corruption endemic in the development of this market is widely perceived. Some lawyers believe that the worst thing about Russian officials is their eagerness to participate in commercial projects. The asset stock, recently transferred to them during decentralization, represents a potential source of revenue. Local officials, fortunate enough to possess clear title to significant assets, sell them off and use the proceeds for current expenditures¹³² or try to use them as equity in joint ventures with foreign investors¹³³, looking forward to the revenue flow from the projects once completed. As participants in joint ventures, they make decisions that do not necessarily bring income. They are not very interested in the legal-commercial side of the deal. Instead, officials involved in the 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 these relations. As compensation for their services, these officials may sometimes receive a portion of the output in-kind (office space for example) or shares in the development company.

The monopoly held by city managers on both commercial premises and land has led to problems of its own. In Moscow, public-private co-operation projects should be avoided for the following reasons:

¹³² This also happened in the Czech Republic.

¹³³ Hungary, Romania, Moscow.

- a) Documents and legal procedures are often lengthy and complicated, the initial backing required may be prohibitive, taxation difficulties can arise, and the initial legal and advisory costs can be relatively high;
- b) Local authorities may be moving into areas where they have relatively little experience and know-how;
- c) Such actions introduce unfair competition in the market, as the developers involved in these deals unlike private legal entities do not pay property taxes;
- d) The benefits to the community fail to accrue;
- e) Local governments should be “entrepreneurial” in the way in which they manage their budgets, and not by investing in risky real estate projects. In a period when the Russian economy is struggling to make the transition into a market economy, activities of such kind should be outside the scope of local governments.

8.7 Summary and Conclusions

In the past few years, there has been a shift in the way real estate projects are financed in Russia and particularly in Moscow. The construction activity in Moscow would seem to indicate that capital is plentiful for new office development projects. However, when looking more closely, one realizes that development capital remains constrained.

In trying to identify the major sources of financing for new office development, opinions vary: foreign players claim that most financing comes from abroad; local developers insist that the majority of real estate projects in Moscow is funded with Russian money. Nevertheless, both groups agree on the fact that most office development in Moscow comes primarily from private equity.¹³⁴

¹³⁴ According to Paul Tatum (president of Americom) expressed in an interview published in the Russian Realtor/Business in Russia September-October 1996 issue under the title “Poised for a Boom”, p.8.

During the first years of the transition, most developments were financed by future tenants in the form of 2 to 4 years' lease prepayments. Possibilities for equity and credit financing have been limited despite the fact that the Moscow office market offers attractive opportunities for high returns. Although in developed market economies credit is the usual source of financing, in Moscow there is still no investment market-only a developer market, with most projects being financed by construction companies themselves. The lack of real cost-effective long-term debt and equity financing has restricted the supply of fully financed high quality office premises. As lease prepayment periods came down, the market continued to experience high rents and an oversupply of low quality office premises.

This situation, combined with political opposition of city officials to private property has left much of the development initiative with the Moscow City Government. In practice, local officials, having no real estate-specific knowledge, take advantage of their possession of clear titles and often move between employment in the public and private sector, granting development approvals, underwriting loans at favorable conditions, and contributing city land to joint ventures with private partners. Such activities introduce unfair competition and prohibit the development of efficient markets for commercial real estate finance.

8.8 Future Trends

Over the next years, market participants in financing new office development will be limited to a few international equity sources, the EBRD for debt financing, a number of early developers who built up a stable cash flow from properties, and a growing number of sophisticated Russian developers, financing their projects through Russian equity, city sponsored loans and third party equity investments. Due to the recent crisis, we do not expect to see any major development activity resuming for the next 18 months,

as the market expects negative absorption rates well into 1999. In the meantime, assuming that some of the structural problems are resolved, it may well be possible for developers to procure reasonable financing by the year 2000.

In the future, the Moscow City Government will need to take guidance from other “economies in transition” such as the Czech Republic and recently Poland, and adjust its legal regime to western practices, familiar to most international investors and developers. The ability of the Moscow City Government to raise finance in the international markets is likely to decline as Russia’s credibility has evaporated in the eyes of most major international financial institutions. Over the long term, the next five to ten years, the market is expected to become more like Western Europe and the United States. In particular, it is likely that more equity investors will invest directly and with partners. International banks led by German, French and American banks will start providing construction loans. A number of Russian banks will choose to specialize in real estate lending. Long-term debt will become available from international lending sources and investment banks as risk premiums decline for Russia and the markets mature. The financing market will change for better. The speed of change will depend on the degree of commitment of the Moscow City Government to develop a favorable legal and institutional environment in the market for commercial real estate.

Chapter 9

The Construction Process in Moscow

The reconstruction of post-Soviet economies in most countries of Central and Eastern Europe is reflected to a great extent in a booming construction sector. The majority of the capitals in these countries resemble a large construction site. Most of this construction activity is driven by demand from foreign investors for international quality office, retail and residential space. The situation in Moscow is no exception. In fact, the construction boom here is more prominent and intense than in any other city in the region. Meanwhile, inefficiencies in the construction sector have contributed to the shortfall of quality office premises in Moscow.

This chapter will focus on the problems encountered in the construction phase of development and the role of the local government in facilitating the construction process and in supporting improvements in the construction industry. Like in the previous sections of this study, the problems are different for local and foreign contractors.

The first part of this chapter is dedicated to the construction sector in Moscow. We then move to examine conditions in the market for the three basic inputs in the construction industry. We begin by looking at the market for building materials in Moscow and how it has developed over time. Later, we continue with a discussion on labor productivity in the Moscow construction sector. Finally, we shift our focus to examine how construction technology affects the supply of quality office premises in Moscow. The chapter closes with a section on conclusions and future trends on the Moscow construction industry.

9.1 Overview of the Construction Sector in Moscow

Our overview on the construction sector in Moscow will begin with a reference to the history of the sector since the Soviet Era. We then continue by discussing the results of privatization of the sector, followed by an analysis of the institutional framework regulating market relations in the Moscow construction industry.

9.1.1 The Construction Sector in the Soviet Era

The construction sector has historically been neglected under the former Soviet regime due to the fact that: a) it had no real use to the military and b) its basic output, immovable property, was not exportable to the western world, thus had no value in hard currency. Building materials were the only tradable goods within the construction industry. Yet, in the Soviet system, a policy of using the simplest technologies imposed the exclusive production of materials of such quality that could never meet western standards and become exportable. Above all, construction activities were viewed as a financial burden that diverted resources from more valuable uses and that should be carried out at the lowest possible cost.

Construction was one of the activities falling under the auspices of the central planning agency of the former Soviet Union (GOSPLAN). In the past, the construction sector was primarily supported by the need for the state to provide housing accommodation to its citizens. Gosplan determined the amount of housing each city or district would construct in a given year as well as the appropriate financial resources necessary to implement this plan. The plan was then given to Gosnob, the central agency controlling all material distribution and allocating materials for military and industrial construction as well as for housing.

Gosplan and Gosnob constituted the state level authorities that gave directives regarding housing production and material supply. Implementation in Moscow took

place at the local level through the Moscow City Council, one of its members being a commissioner responsible for securing the necessary building materials from Gosnob. At that point the process began to break down. The amount of money allocated by Gosplan often did not correspond to the amount of materials necessary for proper construction: money was given without any regard to the availability of materials. When money was allocated, the calculated figures did not reflect the real situation. For example, it might have been stipulated that 1 million rubles should purchase 1,000 tons of concrete. However, material shortages dictated that only 900 tons should be delivered. In reality, the entire building process was at that time practically controlled by material availability.

Due to these policies, the Russian State inherited a construction sector that was characterized by:

- Building materials of poor quality and in shortage
- Low-skilled construction workers
- Outdated building technology

9.1.2 Privatization and the Construction Sector in Moscow Since 1990

The construction industry in Russia is one of the industries undergoing dramatic changes during transition from a centrally-planned to a free-market economy. The heavy transformation of the construction sector is primarily due to its changing role from a financial burden in a socialist regime to an economic development instrument in capitalist societies.

The need for immediate changes becomes apparent when one realizes the importance of the construction industry in the economies of the developed world. Market economies often experience the construction sector being responsible for some 10 percent of their Gross National Product. This, in most cases constitutes the largest sector in the economy and the driving force of multiple related activities in industry as well as is

services. Policies regarding this sector also have a strong impact on not only economic but also on social issues. In Europe promoting the development of major infrastructure networks throughout the continent was a policy design and adopted to remedy for the constantly increasing unemployment rates experienced in most countries of the European Union.¹³⁵

Today in Russia, capital construction has already become one of the main branches of the national economy. Its share in the domestic gross output amounts to 8.5 percent.¹³⁶ There are 125,000 building organizations, 14,000 manufacturers of construction materials and 7,500 research and design organizations in Russia's construction establishment. The industry occupies 7.5 million employees, or 11 percent of the total workforce.

In Moscow, the construction sector is still heavily controlled by the local administration as many of the industries supplying construction materials as well as engineering companies have been transferred to the hands of the government. Another reason why this sector has attracted particular attention by officials is that it traditionally employs a considerable fraction of the working population and therefore has significant implications for the government's social policy.

Moscow is the pioneer of transformation in the construction sector within the whole Russian territory. The city has been very successful in its privatization program for the construction industry, particularly when compared to the average performance in the Russian Federation. In doing so, the Moscow City Government placed the construction sector together with a special group of objects of privatization that includes enterprises influencing formation of market relations to the highest degree. These industries were subject to obligatory privatization by means of their sale to the private

¹³⁵ According to the "White Paper" report produced by the European Commission under the Presidency of Jacques Delors.

¹³⁶ Social-economic situation in Moscow City in January-December 1996: Statistical Collection/Moscow City Committee of State Statistics-Moscow, 1996.

sector at auctions and tenders.¹³⁷ Other sectors included in this group were wholesale and retail trade, public catering and housing utilities, food, and light industries.

Comparative data on the results of the first stage of the privatization in the Russian Federation and in Moscow¹³⁸ show that unlike other sectors where privatization rates in Moscow lagged behind Russian averages¹³⁹, in the construction sector, Moscow has achieved a 53 percent privatization compared to a Russian Federation's average rate of only 16.6 percent. This demonstrates the commitment of the Moscow City Government to promote immediate transformation in the construction industry by privatizing enterprises from the very early stages of the economic transformation process. The process of privatization of enterprises and organizations included in the Construction Complex is now about to be completed.

With its privatization process, the Moscow City Government managed to attract the majority of foreign capital interested in investing in the Russian construction sector. In fact, a great part of the major investment activities in Moscow involved funds set up in the construction sector of which a large share was taken by foreign investors. According to the Moscow City Statistics, more than 90 percent of operating joint ventures in construction in Russia are located in Moscow.¹⁴⁰ Only within four years (1992-1995) there were more than 5,000 investment projects of capital construction realized. In civil engineering, the non-state sector is fulfilling over 80 percent of construction work. From January until June 1996 the fraction of contractual work carried out by organizations of

¹³⁷ According to the relevant legislation, the local government first had to transform the companies into joint stock companies and then to sell them by investment bids.

¹³⁸ As of beginning of 1995. Source: Social-economic situation in Moscow City in January-December 1996: Statistical Collection/Moscow City Committee of State Statistics-Moscow, 1996.

¹³⁹ In the field of public catering, 65 percent of enterprises were privatized in the Russian Federation, whereas in Moscow it was only 50 percent; similarly, in consumer services, the Russian Federation managed a 75 percent privatization ratio while in Moscow the same number was only 56 percent.

¹⁴⁰ According to the Moscow City Committee of State Statistic, as of July 1st 1996, there were 358 operating joint ventures in the construction sector of Moscow with a distribution of 62 percent foreign versus 38 percent Russian capital. At the same time in Russia there existed 399 enterprises occupying 8,773 employees with a 70 percent foreign and 30 percent domestic capital participation.

mixed ownership amounted to 43 percent against 32.9 percent for the same period in 1995.¹⁴¹ For private organizations the same number decreased by over 20 percent in one year.¹⁴² These statistics reflect the tendency of foreign contractors to team up with local partners for reasons that will be explained later in the chapter.

Today, following the recent transformations, Moscow's construction market is divided into two distinct areas with very little crossover between them: low-paid Russian builders who slap together pre-fabricated concrete-slab mass structures (primarily housing), and foreign firms like Enka (Turkey), Skanska (Sweden), or Codest (Italy) that demonstrate their skills on high-profile projects.

9.1.3 The Institutional Framework

As with all sectors of the economy, the success of transformations in the construction industry in Moscow, rely on the ability of the local government to develop the necessary institutional framework to regulate market relations. Privatization of the local construction sector has been the first step, necessary, yet not sufficient for the transition process. Recognizing this fact, the local government has engaged in the development of a comprehensive legal framework on construction since the very early stage of construction privatization. During this process, the city government adopted 56 normative and legislative instruments in 1995 and elaborated the Housing and Town Planning Codes. It is envisioned that the new legislative system will incorporate the application of norms and rules that take into account the European standards.¹⁴³

While the legal regime is still under formation and remains complex, the Department of Construction under the Moscow City Government has become one of the most active participants in the Moscow construction market. In an effort to support the

¹⁴¹ Social-economic situation in Moscow City in January-December 1996: Statistical Collection/Moscow City Committee of State Statistics-Moscow, 1996.

¹⁴² 37.8 percent against 46.1 percent for the same period in 1995.

¹⁴³ The work over certifying construction produces is also under way.

local industry, the Moscow Construction Complex commissions about 3 million square meters of new construction annually. A significant portion of the municipal construction is financed from the Moscow City budget¹⁴⁴, including subventions and revenues from the sale of various types of municipal property (housing, incomplete construction projects, land leases) in the free market. The government bodies responsible for these activities are the Moscow Property Management Committee and the Municipal Property Fund. Other sources of financing city-commissioned construction include private investments and the federal budget.

The development of the construction sector in Moscow has also relied heavily on conditions in the banking sector and on the ability of contractors to raise “cheap” financing during construction. These conditions have not so far proven to be as favorable as initially envisioned. Construction loans have been considered highly risky and have only been possible when the developer or contractor is controlled by the bank. In August 1995, a bank crisis hit some of the banks catering for Moscow’s building organizations and impaired the financial situation of a number of contractors. Soon after the crisis broke out, Moscow construction companies found themselves being owed an astronomical USD 600 million. As conditions in the market improved over time, the refinancing rate dropped from 200 percent in April 1995 to 28 percent in January 1997.¹⁴⁵ Given the recent crisis, refinancing rates have seen tremendous fluctuations.

The problem of financing the construction process became even more acute as construction costs continued to rise as a result of increasing “hidden” costs, in the form of unreasonable fees charged by government departments. Moreover, the Value Added Tax on construction costs is irrecoverable and must be capitalized into the cost of the building further increasing total development costs.

¹⁴⁴ In 1995 USD 1.5 billion were allocated to the Construction Complex from the City budget.

¹⁴⁵ Tkachenko, Andrey. 1998. Key Short-term Indicators for Russian Economy. Moscow. The Urban Institute.

The government experts and investors are aware of the fact that the construction sector will not resolve its problems without actively penetrating into the financial markets (including international markets). To support the construction industry, the local government proposed in 1996 the issuance of municipal bills backed up by real property. Moscow authorities also intend to deepen and expand tax privileges for builders and investors involved in construction works and to encourage mortgage crediting by all methods.

The heavy involvement of the local government in Moscow gives rise to both opportunities and threats to the overall development of an efficient construction sector. The Moscow City Government has taken the initiative and has completed the first and most important task of privatizing the construction industry. They have also provided considerable support to the sector by commissioning large construction activities and by giving special attention to the improvement of the legal framework and the banking sector. Yet, it is in the later that results have failed to accrue. The most important reason for the failure of these policies is that the city did not make the necessary administrative provisions within its government bodies to allow for equitable and efficient implementation.

9.2 Building Materials

This section will focus on the market for building materials in Moscow. We will first start with a short overview on the Russian allocation system of building materials as it developed over time. Then, we will turn to look at how local policies are affecting the distribution and pricing of building materials, in the framework of developing quality office space in Moscow.

9.2.1 The Past System of Building Materials Allocation

The good functioning of the construction sector strongly depends on the conditions in the market for building materials. In Russia, there has been a chronic shortage of building materials caused by a lack of raw materials, skilled labor, and quality control. Due to subsidized prices and a centralized distribution system, material allocation in the construction industry has historically been based on the ability of enterprises and consumers to access the products, rather than whether they could afford the few products that were available.

Depending on the identity of the entity (state-owned or private enterprise) and the commissioner of the project-recipient of materials (state-commissioned or non-state-commissioned projects), contractors would experience different degrees of access to sources of materials. For example, state enterprises involved in the production of high technology, military or export materials were in a favored status to obtain building materials in the past due to the high priority given to such requests. In this respect, they had a greater chance of obtaining the quantity and quality of materials required. In contrast, low-priority state enterprises would receive some of the construction materials requested, but often not enough to complete the building program established by Gosplan. Building cooperatives, although authorized since 1988 to operate as separate building enterprises, were prohibited to secure building materials through the official state supply agency unless they constructed buildings for the state. Alternatively, building cooperatives, often involved in contracts for private entities, needed to negotiate directly with a factory or to work through a network of personal friends.

In summary, there existed 4 major channels of building material supply in the former Soviet Union:¹⁴⁶

- a) The State, directly, through its central agency for material distribution, Gosnob, or indirectly, through state retail stores which were often out of stock.
- b) The black market operating as a secondary market throughout the Russian territory. With connections and back-alley deal making, virtually any material could be bought on the black market for a price.
- c) Imported Materials that co-operatives or individuals were allowed to buy with hard currency from foreign contractors operating within the country, or that they could import directly from abroad. Direct importation was a very costly process that was unrealistic for most local contractors who had no access to hard currency.
- d) Factories: state-owned enterprises in construction that were allowed to sell materials to workers. Supplies were either produced in the factory, or were "excess" materials bought from Gosnob. Factories also sold materials in the secondary (black) market. Materials were also lifted from factories by workers under the communist regime proclaiming that "everything belonged to the people" and therefore people should have rights to access.

Factories constituted a very strong link in the building process not only because they produced concrete panels, but also because they had access to materials. Access to materials provided a power base for obtaining other necessary items. Over the last few years, as material shortages increased, the stockpiles of materials in factories also increased. As materials became scarcer, they became more valuable in the black market.

146 Cryer, Margaret. 1990. "Housing in Leningrad: Then Inefficiencies of the Production Process." Massachusetts: The Massachusetts Institute of Technology.

Increasing opportunities for profits made in the black market induced factory workers to extract materials from the housing production line, and sell or barter those materials for their own benefit. This has aggravated existing material shortages and has created artificial inflation.

9.2.2 The Current Market for Building Materials in Moscow

At present, unlike Russian enterprises that are still partly subject to the dictates of the state allocation plan, foreign contractors are in most cases given the choice of either using domestic raw materials or importing them from the West. The state allocation system allows the distribution of raw materials to foreign ventures, under the following constraints: First, materials available to foreign enterprises are limited to concrete, cement, steel, gravel, sand and limited amounts of lumber. Thus, importing other building materials, including mechanical, plumbing and electrical components as well as finishing materials is required. Second, the availability of these materials is constrained by the same production problems that affect all building materials within the former Soviet Union, namely, a shortage of skilled workers and absence of quality control.

Factories in Russia, due to the outdated equipment and the under-developed employee skills, have virtually no ability to diversify their product. From time to time changes are made regarding size, but the basic attributes of the materials remain unchanged. Hence, the quality of materials is frequently such that they can't be used for the construction of international quality office premises. Finally, the experience of foreign construction firms indicates that a fall back strategy for getting the materials delivered on time is mandatory. This logistical constraint adds project risk due to down time, delays and the costs of contingency planning.

9.2.3 Local Government and the Market for Building Materials

Recession in the Russian economy has persisted seven years already, accompanied by an acute investment “hunger”. The setback in investments has harmed among others¹⁴⁷ the industry of construction materials. The Moscow City Government has taken serious steps towards improving conditions in the local market for building materials that include:

- a) Financing construction materials importation
- b) Financing local industries in construction material production, and
- c) Supporting the modernization of the local industry for building materials by financing Research & Development activities and technology transfer

The above policies clearly demonstrate the commitment of the local government to support the market for building materials. However, the effectiveness of these policies is questionable in view of the fact that the Moscow City Government, at the same time, reserves the right to regulate prices and tariffs for these materials.¹⁴⁸ At present, customs and tariff rates on fixtures, fittings and equipment (FF&E) are still high. Whilst basic construction materials, bricks, mortar, structural steel have tariff rates below 15 percent, the rates for FF&E items are typically above 20 percent. Contractors are more likely to import FF&E and use local bricks and basic materials. The impact of tariff rates is sometimes an issue that is overlooked as average duty rates are used in assessing the feasibility of projects.

¹⁴⁷ The industries of machine building, metallurgy, chemicals, food and to a lesser degree light industry.

¹⁴⁸ In accordance with the resolution of the Mayor of Moscow No 853 of 27.10.95 “On Perfection of Price and Tariff Policy in the City of Moscow”, the Government of Moscow was authorized by the Government of the Russian Federation to regulate prices and tariffs in the domestic market for a list of products and services including building materials.

Control over prices and tariffs on building materials hampers the development of an efficient and competitive market for construction materials. It also increases the risk of corruptive behavior by adding more discretionary power to the officials who at times can decide to act in favor of certain parties in the production or distribution sectors. Instead of subsidizing production and consumption of local and imported building materials under restrictive policies of pricing and material distribution, it would perhaps be advisable for the local government to concentrate its efforts on market deregulation, allowing competitive forces determine supply, demand and prices for all construction materials.

9.3 Labor Productivity in the Construction Sector

The skill level of Russian builders is not sufficiently developed and has steadily declined over the last few years. According to Turkish architect Murat Gulmezoglou, Moscow builders work at a slower tempo and are poorly paid an average income of USD 200/month.¹⁴⁹ This factor has been a major contributor to the office construction shortfall and the poor quality of the existing buildings.

The recent deterioration of local construction workers' productivity can be attributed to: (a) the low prestige associated with manual labor during the transformation from an industrial to a service-oriented economy, and (b) the recruitment of unskilled labor from the countryside to fill in the need for construction workers in Moscow. Even when financially motivated by foreign companies that sometimes offer double their normal salary, local workers' productivity remains in general very low. Moscow builders are usually not motivated, do not speak English or other foreign languages and are not experienced with foreign technologies. This works to the advantage of foreign

¹⁴⁹ Figure for 1995, according to the annual statistics from the Department of Construction in Moscow.

contractors, often invited by the city to undertake construction and reconstruction of international quality developments.

Initially, the government, using hard currency reserves, hired Finnish and Swedish construction companies to work on priority projects in Moscow and St. Petersburg.¹⁵⁰ Later, contractors from other countries also managed to penetrate the Moscow market, among which Turkish companies have the strongest local presence. Their competitive edge can be seen in projects such as the office complex in Taganskaya, where Turkish company Enka managed to build 20,000 square meters in only 6 months, a structure that would normally take any Russian contractor at least 2 to 3 years to complete.

Today, real estate joint ventures are also faced with the same problem of finding skilled labor locally. These developers often follow the city example of hiring foreign contractors already doing work in the region for many years who can be easily mobilized for projects of any size. Widespread use of such companies has induced productivity improvements for the local contractors by: a) setting benchmarks in terms of speed, cost, and quality of construction, and b) facilitating the transfer of knowledge through their interaction with local workers.

In an effort to support productivity improvements, the government has in past promoted two schemes: The first one is related to the implementation of training programs while the second refers to the application of incentive programs for local workers. Yet, in absence of project monitoring, the programs were merely used as marketing schemes.

At present, limitations in the local market for skilled labor impose the almost exclusive use of foreign contractors for construction of international quality office buildings. These companies usually take over the role of the general contractor, using expatriates as senior engineers, who while on the payroll earn 4 times the salaries of local

¹⁵⁰ Examples of such projects are the renovation of historic hotels Astoria and the Metropole.

employees (an average of USD 800/month). Hiring Russian workers to carry out subcontracting activities still bears the risk of not meeting delivery time and of ending up with lower than acceptable quality of construction. For this reason, general contractors prefer subcontractors from the CIS (Commonwealth of Independent States), Yugoslavia, and Turkey which are paid an average of USD 300 per worker per month and who can meet the quality and time restrictions of the projects.

In the next 5 years the situation is expected to change. Russian companies will soon be able to build at the same pace as their foreign competitors and guarantee the same quality. Competition will therefore intensify in the market for builders, to the benefit of future developers and investors who will be faced with decreasing construction costs.

9.4 Construction Technology

Construction technology is the third and most troublesome input in the construction process for new international quality office premises in Moscow. In order for the reader to gain a better understanding of the current conditions in the market for construction technology, the section will begin with a few words on the standardization of Russian building technology, as inherited from the past. We will then continue by discussing technology innovation within the construction sector in Russia, and more specifically in Moscow. After analyzing the role of the Moscow City Government on the promotion of construction technology innovation, the section will end with an assessment of the impact of foreign contractors on technology transfer in the course of developing new office buildings in Moscow.

9.4.1 The Standardization of Russian Building Technology

The local construction sector has suffered and continues to suffer greatly from a lack of international quality building technology. The standard and probably single

technology used by Russian contractors is that of large-scale pre-cast concrete panels. It is not surprising that this has also been the unique method used in state-produced housing. The decision to use panels was made by bureaucrats during the time of the Soviet regime on the following grounds: (a) standardization of parts made them quick and easy to assemble on site, minimizing the number of workers and the time exposed to unfavorable weather conditions and (b) the method of panelized construction did not require a high skill level to assemble, so that skilled labor could be used in more strategic sectors of production (machine building for the military etc.).

Manifestations of this philosophy are still embedded in the development process today because of four primary reasons: First is the significantly higher production output that the Soviets have realized using this system. Second, they feel that concrete is a more efficient building material: they can meet their minimum quantity standards and yet produce on a mass scale. Additionally, they have access to domestically-produced and relatively inexpensive raw materials, such as cement, concrete, steel, sand and gravel. Third, an extensive infrastructure has been built over the years in line with this technology. The ramifications of considering a change in construction methods would be significant due to their dependence on this one system. The fourth reason is particularly constraining at this time: according to the view of public officials, the use of alternative methods would require different construction materials. This could exhaust some of the main sources of hard currency, for example wood, which is a major export material. Using wood construction on a wide scale would potentially deplete this resource.

Given the inherent resistance of the Russian system to changes in construction technology, how can the construction sector in Moscow build the skills necessary for the development of international quality office premises?

9.4.2 Technology Innovation and the Construction Sector in Russia

The state has historically discouraged technological innovations in construction by the use of direct as well as indirect methods. At the local level, the centralized system has openly eliminated alternative building technologies. For example, in the 1970s, pre-stressed concrete was tested, but the process was too complex for unskilled labor and was therefore eliminated. Other efforts to improve construction technology in Russia that appeared at times were also resisted by local builders. For example, when poured in place concrete was reviewed, the technology was vetoed by local builders although it was less expensive than the panel construction. The reason was that builders preferred simplistic, yet costly methods of production so that they could meet their quotas faster, and with minimum effort (since quotas were based on money spent and not completed works).

Technology transfer was also controlled by the central government, in this case indirectly, by the application of design standards and building specifications limited to the use of pre-cast concrete panel systems. Despite design attempts by foreign contractors to use wooden construction methods, it was impossible to obtain the necessary building approvals. Deviations were not allowed, therefore design and engineering solutions were limited to the building system based on the Soviet commitment to concrete.

Only recently have construction standards in Moscow started to adjust to the standards currently used in the western world. Enforcement of these standards takes the form of certification. According to the law¹⁵¹, it is obligatory that a certificate of compliance is issued against state standards on sanitary norms and regulations,

¹⁵¹ Law of the Russian Federation “on Certification of Produces and Services” dated 10 June 1993.

construction norms and regulations, as well as against safety norms, all of which meet criteria similar to the ones to be found in western real estate markets.

The application of such principles is generally regarded as a positive development. Yet, the Moscow construction sector is still waiting to benefit from such laws. The administrative weakness of the local government, coupled with a complicated set of procedures reduces the ability of the system to operate transparently. Instead, Moscow inspectors seem to be enforcing these standards for their own betterment, rather than for the protection of the public. On this occasion, a kind of local racket has developed, pocketing sizable sums of money when determining the technical conditions for connection to utilities - all under the guise of modernization and expanding infrastructure.

9.4.3 The Moscow City Government and Construction Technology Innovation

Construction technology depends heavily on the technology of the machines used in the construction process. One way in which the City has supported local construction firms has been by facilitating the leasing of construction equipment. This is done through the Moscow Leasing Company. Most machines being leased are of western technologies, a fact that accelerates the process of technology transfer. However, there are two major problems, both related to the administration of the leasing process: The first one is that any leasing transaction is preceded by an extensive amount of preparatory work needed during expert examination of the deal. In particular, there are 8 documents required for the first phase of preparation and substantiation of the leasing transaction and 6 additional documents for the legal formalization of the leasing transaction. As practice suggests, due to the complexity of the process, 90 percent of all proposals are turned down.

According to the structure of the lease agreement, the Moscow City Government, in the person of the Moscow Property Committee (Moskomimushchestvo), owns the construction equipment until the end of the lease and until the lessee has made his final

payment. During this period the company pays no taxes on this equipment. Here is where the second problem arises: as all applications are processed by the local government, it is up to the discretion of Moscow City Government officials to “favor” certain contractors by “facilitating” the leasing of their equipment, at the same time that their competitors have to purchase their own machinery and pay taxes on it. This introduces unfair competition among local contractors. To be able to take advantage of the leasing process, one has to have direct contacts with high-level city officials. In practice, what we usually observe in Moscow is few of the largest local contractors actually purchasing their own equipment.

As a means towards improving the effectiveness of the leasing policy, the Moscow City could consider the following steps:

- A. Simplify the application and leasing process by reducing the amount of documentation required
- B. Provide technical assistance to the city officials by inviting experts; by improving their financial skills, city officials will be able to process the applications efficiently and assist applicants in the preparation process, so that the majority of applications are approved;
- C. Transfer the responsibility of application processing from the city level to the local financial institutions. This will minimize the power of city officials to act arbitrarily and will therefore reduce corruption incidents. In addition, it will increase efficiency as employees working at private banks in Moscow are in general well-trained and more capable of performing such transactions than local officials. Of course, such action would most likely generate strong opposition from the local administration. It remains however a necessary step towards the development of a true market economy, where most activities are not only

decentralized from the federal to the local level of administration, but are truly divested to the private sector.

9.4.4 Foreign Contractors, Technology Transfer and the Office Market in Moscow

While some of the state-financed housing continues to be produced under the same "old" technology standards, commercial buildings for international office occupiers are not able to tolerate poor quality. Even when it is the local government acting as the investor or developer it is usually foreign contractors that are being hired to undertake such demanding in quality and speed developments. Foreign builders possess state-of-the-art technology. This is why they are preferred not only by the public sector but also by local developers, often forming joint ventures with foreign partners. In one of the successful Russian projects the Tver Universal Park, the US-based project manager Archinomics Group combined local skills and materials with imported prefabricated components as needed and helped the local economy through technology transfer.

International contractors working in Moscow offer short-term assistance to the Russians during the transition period. They employ highly skilled workers from Germany, Turkey, Italy, the United States and Scandinavia. They have the latest in electrical tools and trucks. The sites are extremely orderly with strict safety precautions evident. All tools, trucks, and equipment plus 99 percent of the materials are brought by truck from their home countries. The only materials still bought from the Russians are sand, gravel, cement and reinforced steel. Most companies would have preferred not to buy any materials from the local market, but such provisions are often stipulated in their contract.

However, the wealth of knowledge and resources which the contractors have access to is slipping between the cracks. Although new technologies in construction succeed in increasing productivity and quality and in reducing costs, new office developments in Moscow can only partly benefit from the use of such technologies as

they are not yet available to local builders. Foreign contractors, acting in a somewhat oligopolistic manner, charge construction costs that are very high due to the fact that machinery, materials and labor often need to be mobilized from their home countries. According to 1996 data, construction costs of prime office space amounted to an average of USD 1,500/square meter. These levels are higher than construction costs in western economies where similar materials are used, but where worker's salaries are 4 times higher than the ones paid to local workers in Moscow. This is primarily due to the cost of importing most materials and labor from abroad.

Over time, as more local/foreign joint ventures are gradually formed to build commercial premises in Moscow, technology will inevitably spill over the local partners. It is therefore reasonable to expect that it will not be very long until local contractors are able to use such technologies themselves and produce international quality office space at a cost competitive to the one currently incurred by developers in Moscow.

9.5 Conclusions and Future Trends

During transition in Russia most of the construction process in Moscow is being decentralized. The Moscow City Government has made significant progress in privatizing most of the sectors related to the construction industry and in promoting advanced technology. However, the Moscow construction sector still suffers from a severe need for deregulation. Local government control over prices and tariffs for some of the most important raw materials in construction, arbitrariness allowed in the process of leasing equipment, of licensing buildings, and the use of double standards are only few of the factors that reduce competitiveness and hold back the process of developing an efficient construction market in Moscow.

Local builders are primarily concerned with finding the hard currency to import building materials and with upgrading their technology and management techniques,

while international contractors often find it difficult to purchase basic building materials in the local market under conditions of centrally-controlled supplies and prices. Finally, the industry also suffers from low productivity rates and to a lesser degree from a lack of western-type building technology, a result of a traditional bias towards a homogeneous construction technology.

The recent crisis has hit hard the construction sector as the pace of construction has been dropping and is expected to remain low for the next 18 months. The currency devaluation has made not local materials cheaper. However, the only local material new prime office space construction uses is pre-cast concrete. At the same time, importing quality materials, finishes and equipment from abroad has become even more expensive for the local contractor. Similarly, the cost of local labor has somewhat fallen since local workers are not allowed to be paid in hard currency, while the cost of western engineers has skyrocketed for the local construction companies.

At the end of the day, the ability of the construction sector to respond timely to the needs of the market for prime office space in Moscow depends on the ability of the foreign contractors to team up with a local partner, to overcome the administrative difficulties, and to timely mobilize resources, in the form of capital, building materials, labor and equipment at a reasonable cost.

In the future, it is likely that the market will be dominated by Russian contractors, carrying out real estate construction works even for foreign developers. Smaller local firms will most probably continue to work as subcontractors to the local and international general contractors. In the medium term, we may also see some consolidation in the contractor's market. All these developments will eventually benefit the supply side of the local market for office premises. At decreasing rents, developers will be able to maintain their returns as construction costs will also adjust downwards due to competitive pressures coming from the local contractors and continue to build new office space in Moscow to accommodate persisting demand.

Concluding Remarks

In the Moscow market for new quality office development many projects remain far more developed on the drawing board than they are on ground. A variety of factors conspire to delay even the best-laid plans. Many of these factors are related to the activities of the local government. At the planning stage, there are numerous hurdles to overcome in dealing with dozens of city officials that need to sign off on any significant construction work. Even after all planning is successfully completed, projects are often interrupted during the next step in the development process, land acquisition. In the absence of clearly defined land and property rights and of a city master plan and zoning legitimate uses for different areas in the city, land leasehold privatization becomes a timely and often very costly process for land acquisition. Furthermore, securing financing in the absence of Mortgage Law and of an efficient system of rights registration is impossible. Therefore, most developments need private equity or the intervention of the local government to secure financing.

One of the most unique characteristics of this market is exactly this: the willingness of the public officials and of the city government to switch back and forth between the public and the private sector, forming a joint venture with a private entity often foreign in order to capitalize on rights they may have access to through their state positions.

What is effectively happening in Moscow is an “institutionalization of corruption” where all functions commonly performed by the state in free-market economies, provide the grounds for the creation of special legal entities to carry out endless negotiations with the private offices on a case-by-case basis on behalf of the government and in most cases to the personal benefit of the public officials.

Even when the state, taking advantage of its privilege of being the only landlord in Moscow, sets up projects with the ultimate goal of attractive foreign investment later in

the process, it is still advisable to avoid public/private partnerships in real estate. This is because such agreements are usually structure in a way that introduces unfair competition in a market that remains heavily underdeveloped.

The country's recent political and economic instability has caused more concerns to professionals throughout the commercial property market. However, the recent devaluation of the ruble while putting pressure on tenants tied up in USD denominated leases, it has also made land, one of the most expensive input for any project, cheaper for foreign developers having long-term land leases often denominated in local currency. The current recession should ultimately give a healthy strike in the direction of competitive restructuring as it is rather likely that most state-initiated building activity will be eliminated due to the need to reallocate resources for the budget. In the short term, expect to see most tenants locked in USD denominated leases to try breaking and renegotiating the agreements. Companies who have bought their own premises may well right them off their books as soon as possible and move to rental properties. It is also likely to see a few foreign companies, the ones not related to the financial markets or consumables, taking up some additional space as rents fall and more space becomes available through construction of buildings currently under way.

Given the new development already underway and limited new demand for class-A premises, we may observe negative absorption rates well into 1999. This will give the state adequate time to complete its efforts in reforming the real estate market by developing the following:

- a) **The necessary laws** to guarantee the operation of a competitive market for land, construction material and processes, and development financing. Part of this reform effort should also concentrate on separating federal and local government

responsibilities and activities in order to avoid the problems of conflicting or overlapping legislation and duplication of procedures.

- b) **The commitment by officials** to implement the designed laws and to act in the interest of the public. We recognize that this may take much longer to attain.
- c) **A reliable court system** that guarantees law enforcement by all parties in the private and the public sector, protects the rights of individuals, efficiently resolves conflicts.
- d) **The necessary institutions** to monitor the market functions supported with the provision of technical training of key personnel on property issues.
- e) **A vision for the local government** that minimizes “entrepreneurial” behavior of the city and its officials and limits its role to the establishment of the necessary framework to allow competing market forces take over all sectors of the economy including real estate.

APPENDIX
Examples of Office Development Projects in Moscow

Project Name	Compl. Date	Developer	Dev. Cost	Sqm	Av. Cost	Rent/\$/m/year	Contractor	Tenants
Until 1995								
Moscow Business Plaza	1991	Intourist	N/A	11,800		N/A	(Yugoslavian)	Texaco, Goodyear, BBC
Park Plaza Moscow	Dec-92	UpDK	N/A	75,000		N/A	MIR	Lia Oil, Hoechst, Deutsche Bank
Mosenka II	Mar-94	Mosenka	9,500,000	3,840	2,474	800	Enka	Linklaters & Paines, HIB
Nikitsky Per.,5	1994	ST Group	57,000,000	22,840	2,496	N/A	Elbert	CSFB, Exxon, IMF
Mosenka Plaza III	Jan-95	Mosenka	19,000,000	7,700	2,468	700-800	Enka(Turkey)	Clifford Chance, Eli Lilly, Salomon Brothers
Mosenka V	Aug-95	Mosenka	8,500,000	3,500	2,429	650-725	Enka	Coudert Brothers, Alcoa, Pioneer
Japan House	Sep-95	Saison Group	37,000,000	14,900	2,483	850-1000	Skanska (Finland)	Itochu, Panasonic, Renaissance Capital
Patriarshy B.C	Q4 1995	Astra 7	31,000,000	12,500	2,480	N/A	SCT	Vitalis, Bristol Myers Squibb
West Bridge Business Ce	Oct-95	West Bridge Ltd.	N/A	5,000		N/A	West Bridge (Sweden)	Coming, Shelton Consulting, Clintondale Aviation
Mosenka C Plaza	Dec-95	Mosenka	10,000,000	4,000	2,500	750	Enka	L'Oreal
Mosenka P Towers	Dec-95	Mosenka	50,000,000	20,000	2,500	720-800	Enka	Compaq,Bay Networks, P&G
Hamilton Standard	Q4 1995	Hamilton St.Nauka	9,000,000	4,500	2,000	N/A	Hakka Moskva	Hamilton Standard Nauka, Satcom-Tel
1996								
Elbert Place	Jan-96	JSC Tesso Premier	4,000,000	2,100	1,905	800-900	Elbert Ltd.	Sakhalin Energy Consortium
Pushkin Plaza	Mar-96	JSC Tverskaya 16	50m(total)	10,000	N/A	825-925	Alarko	DTZ, Nat West Markets, Mars
Sadovnicheskaya 4	Mar-96	S+T Group	N/A	3,350	N/A	Sold	Conoscia (Italy)	N/A
Riverside Towers	Apr-96	Moskva Krasnye Holmy	N/A	19,700	N/A	800-900	Enka	Arthur Andersen, Hewlett Packard, GE
Mc Donald's 1905	May-96	Moscow Mc Donald's	6,500,000	2,500	2,600	800	SRV Terasbetoni	ING Bearings
Toko Tower	Q3 1996	Toko Bank	37,500,000	15,000	2,500	N/A	AMR	AT&T, Pfizer
Patriarshy Ponds	Jul-96	Tver-Universal Bank	N/A	12,000	N/A	N/A	SCT Slovenia	Goldstar, Lq Electronics, Bristol Myers, Squibb
Balrchug 3/5	Aug-96	S+T Group	N/A	1,300	N/A	Sold	Bureau Robinstroi	N/A
Malaya Yakimanka 2/4	Aug-96	S+T Group	N/A	12,500	N/A	N/A	N/A	N/A
Gogolevsky 11	Oct-96	Krest	22,000,000	7,400	2,973	850-950	Codest Eng. (Italy)	N/A
Sokol 10 B.C.	Dec-96	CIED	12,000,000	6,000	2,000	575-750	Ros	Microsoft, Intel, BMW, 3COM
Chaplygina House	Dec-96	Enka	N/A	170	N/A	750	Enka	Regent Pacif., Edison Inv.
1997								
Ulansky Center	Q1 1997	Sawatzky Group	17,000,000	7,100	2,394	sold at 26m	Swatsrtoi	Avon, Rhone-Poulenc,Shell Exploration
Olsufievsky 46	Q1 1997	Supply & Management	N/A	1,200	N/A	750	NPC Edinstrvo	N/A
MKWKS Business Center	Q1 1997	MosVodoKanalStroy	N/A	3,000	N/A	675	Summa	N/A
Luzhniki Alliance Bldg.	Q1 1997	Luzhniki Alliance	N/A	4,000	N/A	700	Yapiter	N/A
Prospect Mira 72	Q1 1997	Cerit	N/A	30,000	N/A	700-800	Passiner	N/A
Riverside Towers	Jan-97	Moskva Krasnye Holmy	N/A	860	N/A	750	Enka	Unilever, RCI, Levis, Fujitsu Daftrucks, Panalpina
Smolensky Passage	Q4 1997	Tema	75m total	19,000	N/A	800	Skanska	N/A
Tanora Place	Q2 1997	Tanora A.G.	20,000,000	8,000	2,500	N/A	Medimurje	N/A
Donskoy Posad	Apr-97	GlavUpDK	26m tot.	2,500	N/A	750	EMT	Price Waterhouse
Arbat Center	1997	AOZT Syracuse	N/A	34,000	N/A	900	N/A	N/A
Polyanska Business Part	Q3 1997	KRT	12,500,000	5,000	2,500	680-750	Skanska	N/A
Meta Dom	Q4 1997	Sberbank of Moscow	16,000,000	8,000	2,000	580	B&M Construction	Price Waterhouse, Henkel Ecolab
Ducat Place II	Jun-97	BrookMil	35,000,000	20,000	1,750	800-850	Codest Engineering	Motorola, Lukarco, Conoco, Freshfields
Usadba Center	Jul-97	dba AOZT/Moscow City Govern	50,000,000	20,000	2,500	800-1000	Entes/SRV Terasbetoni	RJ Reynolds, Cho Hung Bank, Flemings
Efimia Center	Q3 1997	Tarina	21,000,000	8,500	2,471	N/A	Darjan Int.	N/A
Yakimanka Plaza	Q3 1997	Samsung	16,000,000	6,500	2,462	N/A	Samsung	N/A
Gnezdnik B.C.	Q3 1997	Samsung	28,500,000	11,500	2,478	N/A	Samsung	N/A
Shepkina 4 Office Dev.	Q3 1997	Koltchuga Fund	N/A	5,000	N/A	725	N/A	N/A
Meyerhold Center	Aug-97	JSC Novoslobodskaya	60,000,000	25,000	2,400	750-850	Elbert Ltd.	Norilsky Nickel, McDonalds
Keystone Property	Q3 1997	JSC Keystone	37,500,000	15,100	2,483	800	Turan	UES, Alcatel
Timurafunze	Aug-97	S+T Group	N/A	6,670	N/A	N/A	N/A	N/A
Embankment Place	Dec-97	Capital City Dev. Ltd.	100m tot.	21,759	N/A	650-925	N/A	N/A
Pavelets. Sq.-1	Dec-97	Enka	32,500,000	13,000	2,500	750	Enka	BP-Mobil Oil, JP Morgan, Nestle
Garden Ring Bldg.	Dec-97	CIED	8,500,000	3,500	2,429	700	Ros	Caterpillar, Schafer Shop GmbH
Alexeevsky House	Dec-97	Sawyer & Co.	5,000,000	3,000	1,667	800	TEPE (Turkey)	N/A
Chaika Plaza	Dec-97	JSC Zubarevsky	45,000,000	20,000	2,250	N/A	MIWEL	N/A
Technopark	Q4 1997	JV Technopark	17,000,000	7,500	2,267	N/A	Alarco Alsim	Ranbaxy, Elfert

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Project Name	Compl. Date	Developer	Dev. Cost	Sqm	Av. Cost	Rent\$/m/year	Contractor	Tenants
1998								
Pokrovskye Vorota	Jan-98	GlavUpDK	27,000,000	10,800	2,500	625-675	Konip	OPI, Iskra Bank
Novinsky Gardens	Jan-98	Tirtamas Comexindo	15,000,000	6,500	2,308	N/A	McHugh	N/A
Olympic Plaza	Jan-98	Rugoz	37,500,000	15,000	2,500	N/A	Koling Interpass	N/A
Sadovnicheskaya 3	Q1 1998	S+T Group	12,500,000	5,000	2,500	N/A	Codest Engineering	N/A
Timurafunze 24	Q2 1998	S+T Group	22,000,000	8,700	2,529	N/A	Codest Engineering	N/A
Four Winds Plaza	Q1 1998	S+T Group	N/A	48,000	N/A	N/A	N/A	N/A
Aptekarsky Garden	Q2 1998	MCD Group	8,500,000	3,500	2,429	800	Terminal Transit	N/A
1998 Delayed								
Balchug	Q4 1998	S+T Group	N/A	37,000	N/A	N/A	N/A	N/A
Central Tower	Q4 1998	GRAN	112,000,000	45,000	2,489	N/A	Amorade	N/A
Golutvin. Dvor.-2	Q4 1998	Naftam	30,000,000	12,000	2,500	N/A	AMR	N/A
Prospect Mira 72	Q3 1998	Cerit	22,500,000	9,000	2,500	700-800	Passiner	N/A
1999-2000 Delayed								
Zenith Center	Q1 1999	HSIB	250,000,000	100,000	2,500	N/A	N/A	N/A
Meyerhold Center	Q2 1999	Interros	87,500,000	35,000	2,500	N/A	N/A	N/A
MIBC-1st BC	Q4 1999	S+T Group	300,000,000	200,000	1,500	N/A	N/A	N/A
Balchug Plaza	Q4 1999	S+T Group	60m total	21,000	N/A	N/A	Codest Engineering	N/A
Bolshaya Ordynka	Q4 1999	Skanska Oy	35,000,000	17,400	2,011	N/A	Skanska Oy	Reuters
Kadashev. Emb	Q4 1999	F+B Bondi & Partner	25,000,000	12,000	2,083	N/A	Siemens(Germany)	N/A
Alfa Arbat Center	Sep-99	AOZT Syracuse	60m total	21,000	N/A	N/A	N/A	N/A
Sovincentr 2	2000	Sovincentr Inc.	220,000,000	120,000	1,833	N/A	Cinnex	N/A
Meridien Tower		Pioneer First Voucher	45m	23000	N/A	490-535	Bovis	Lucent Technologies, WR Grace

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