

## How Large is Russia's Land Rent?

### How Will it be Used?

by Dr. Michael Hudson

*(Editor's note: In this issue, Dr. Michael Hudson, the new HGS Director of Research, begins his regular commentary on economic issues.)*

What would happen if the land in Russia were privatized in such a way as to let its rent and price gains be taken by absentee speculators — and the mortgage bankers lining up behind them to load this property down with debt?

In June, I travelled to Russia with Nicolaus Tideman to meet with some of our Georgist counterparts and help create a program for local communities to collect land rent. Our first task was to estimate the magnitude of local rental and land values. However, it soon became apparent that trying to determine an economic price for Russian real estate was premature. Security of ownership is unclear in a political environment that continues to be marked by corruption. Real-estate taxes are not being paid, as owners collect rent but avoid divulging their ownership to the tax authorities. In the absence of a legal system defining property rights, there is scant basis for collecting public rents, to say nothing of allocating changes in land values and rent rates between the current users of properties, their localities, and the national taxing authority in Moscow.

Moscow and St. Petersburg are now ranked as the highest-cost cities in the world to live, at least for foreigners. A Western-type hotel may charge \$350 a night. To be sure, there are very few such properties, which is why they are so expensive. The seedy hotel I stayed at in St. Petersburg was mainly for native Russians, and cost just \$35 a night. Everywhere I went, I found a similar double standard. The Moscow art museums charge foreigners \$4, but Russians only have to pay 40 cents. Lunch — if one can find a restaurant — costs about \$25; most Russians skip it altogether, or take it in their company dining rooms.

This double standard has a major effect *(continued on page six)*

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on what Russians believe their apartments and other properties to be worth. A typical Russian apartment is about four rooms, and is occupied by numerous family members, often spanning at least two generations. Such an apartment may be valued at about \$80,000, and some indeed are changing hands at this price. The typical buyer is a foreign company with business in Russia, finding it cheaper to pay this price than to put up its executives in one of the foreign hotels.

But what are most apartments worth, or what would they be worth if there were a free market in real estate? To western-trained economists, property values are based on the revenue they can generate. This in turn reflects what renters can afford to pay. A rule of thumb is that residential tenants are able to pay about 25% of their income as rent. Salaries for skilled professionals in Moscow and St. Petersburg average only about \$1200 a year, suggesting a maximum rent-paying ability of about \$300 — or \$1200 for a household of four wage earners. Meanwhile, Russian interest rates are widely advertised at 33 1/3% per year for dollar-denominated deposits immune from rouble inflation. This indicates a property value of only \$3600 for a Russian apartment (\$1200 divided by 1/3).

How can one reconcile this calculation with prices in the neighborhood of \$80,000? How can a Russian family ever earn the money to buy an apartment at these prices? Few Russians are able to save any of their salary, their rouble-savings have been wiped out by inflation, and foreign accounts are illegal. Many Russians are getting by only by selling assets in the thriving market in family heirlooms.

The explanation is to be found in the remarkable way Russia's property rights were created. At the time of the revolution, most Russians simply were given the apartments they occupied and the farms they worked. Eager to extol the virtues of privatization, President Yeltsin wanted to convince Russians of something they wished to believe in any case: that they were getting rich, at least on paper. Some families exchanged large apartments against smaller ones, providing a thin market from which property values were able to take off.

How can today's property values be supported out of proportion to rental income? Part of the answer is that property is becoming a hoarded good. The Russians have learned to fear their banking system. The "vouchers" that each Russian worker was given as equity in his or her company

were worth only about \$25 each. The largest and most popular stock market vehicle — the MMM mutual fund — has gone bust. Real property seems one of the few investments worth having.

For local authorities, how much tax can such properties be expected to yield? Should they be assessed on their current rental income, or on the largely unrealisable sales values their holders imagine them to have?

Obviously location plays a major role, but most Russians do not seem to be very familiar with this concept. Neighborhoods in central St. Petersburg and Moscow remain most desirable, even though high construction costs are needed to bring these buildings up to western standards. For most of the population, prices in the \$80,000 range are far out of proportion to rent-



yielding ability. A typical salary of \$1200 a year, with four wage-earners per apartment (each paying a quarter of their salary on rent), produces a price/rent ratio of \$80,000/1200, or 61 times. This means that it would take a lifetime — over 66 years — to buy an apartment.

In this respect the Russian housing market has experienced nearly as great a bubble as Japan. For most countries, Russian-style price/yield ratios would imply a speculative market, as most speculation is funded by credit. But there has been almost no mortgage lending in Russia. What makes its case even more unique is that the economy is so poor in absolute terms, unlike Japan and America in the 1980s, Holland in the late 17th century or England and France in the 1710s during the South Sea and Mississippi bubbles.

Suppose that a real-estate market would develop, enabling Russian workers to take out mortgages on their apartments — say, just half their value, or \$40,000. This is almost as much as a Russian can make in a lifetime at today's wage levels. Why shouldn't he take the money and run, retire abroad or invest his money at the going 33 1/3% rate of interest and use just a fraction of that yield to pay rent somewhere else?

Mortgage lenders are not so foolish as to lend under these conditions. The result is that most Russians have little choice but to stay put, for nearly everyone has an inflated view of their home values. Indeed, I found that most Russians put an inflated value on nearly every asset they have, from their apartments and rugs down to their collections of phonograph records and family heirlooms. Many seem to be waiting for "the big kill," the sucker who proverbially is born every minute, to dump his assets at an inflated price.

This does not suggest that Western mortgage lenders should hold their breath waiting to load down Russia's land with interest charges. There may indeed be local would-be Donald Trumps eager to borrow money in exchange for pledging the land as security. But could they reap a high enough land-value gain to pay off their creditors and keep a net balance for themselves? How much higher can the price be expected to rise?

"Foreigners" also are making the market for Russian factories, mines and other enterprises. But in a country with no working legal system, where there is no legal recourse against fraud or embezzlement, it is hard to attract foreign investors. I suspect that when one sees a foreign company putting in \$10 million or more into a Russian venture, it may well be holding as collateral the foreign bank account of some Russian directly involved in the operation. An estimated \$13 billion of Russian foreign exchange reserves have simply disappeared, apparently into the hands of the former bureaucracy, which is now drawing on this money to fund its new operations within Russia.

The upshot is that Russia has progressed far beyond the United States in becoming a postindustrial society. One only can marvel that it offers the highest rate of return in the world (33 1/3%), yet has few consumer or capital-goods industries of its own, save for Stolichnaya vodka. When I visited Moscow's statistical agency and asked how it was possible to compile retail sales statistics in an economy dominated by sidewalk kiosks, I was told that the figure was simply based on import estimates for that month! Little domestic production is occurring except for raw materials. The Russians are surviving by selling off assets and treating these sales as current revenue.

This does not leave much room for a credit system to develop. Without credit, there is little way for real estate values to be confirmed in the sense that we Americans

are familiar.

One must conclude that many Russians are being led to confuse democracy and free enterprise with selling off their land, natural resources and industry to foreigners and to the former Soviet *nomenklatura* who got extremely rich at the very outset of opening to the West. Russians feel rich when they look at the prices widely accepted for the real estate rights they have been given, and see 33 $\frac{1}{3}$ % being offered on dollar-denominated savings. Some mutual funds have experienced a remarkable bubble, with returns of 1000% per year being promised, or at least reported if not actually "earned." But the most popular bubbles already have burst. Matters do not seem likely to improve until more Russians recognize the difference between earning money and simply receiving money for selling off assets. As they sink further into poverty, the danger of a real estate crisis grows.

This problem cannot be blamed entirely on communism as such. Nothing comparable is occurring in China, for instance. While Russian land prices in the large cities (and indeed, food prices and most other prices) are nearly those of the United States, China has kept its land prices and other domestic costs low. Russia exports virtually nothing save raw materials, while China is increasing its exportation of labor- and land-intensive industrial manufactures. China enjoys a major competitive advantage in not having to factor high land-rents into these products. It is not hard to guess which economy will be better placed to export its way out of foreign debt. Land rents are an important element of pricing, as are interest charges, taxes, and the overhead of corruption.

As Adam Smith warned, interest rates often are highest in countries going most rapidly to ruin. He also warned that landlords love to reap where they have not sown. His *Wealth of Nations* is now being translated into Russian for the first time. Perhaps it will help alert Russians to the precariousness of trying to create a *rentier* economy without a productive foundation, living by selling its natural endowments and other assets rather than the products of current labor and capital.

To upgrade the productivity of its existing labor and capital will require a credit system based not on lending against land or other collateral that creditors can seize for nonpayment, but against the new earning power that productive credit may help finance. This is the only way that interest-bearing debt has been able to uplift economies. A debt overhead that leaves productivity untouched would be merely parasitic, not productive. ❖