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Real Estate Advisory Group

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Benefits of Developing Real Estate Markets in Countries with Economies in Transition

Background paper I

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Summary

“Real estate”* plays an essential role in every fully developed market economy in the world. It is an asset that can be traded like any other asset. If traded freely through private transactions, it can increase economic activity and, it is estimated, contribute up to 30% of a country’s gross domestic product. It is therefore essential for any country seriously seeking to achieve functioning market economy status that land rights (in their broadest sense) must be organised in such a way as they can be privately traded. Accordingly, not only must the required legislative and regulatory framework be established by the public sector (the Government and the Legislature), but also the innovative capacity of the private sector must be engaged to provide the funding and exploit the growth opportunities that land as an asset offers.

** The terms “real estate”,“real property”, and “real estate market” mean for the purposes of this paper generally the organisation of rights to land in such a way as they can be traded for value between any individual or entity, such rights being independent of the physical feature generally referred to as “land”.*

Introduction

In the countries of Central and Eastern Europe, which to varying degrees are moving towards functioning market economies, real estate is a largely under-utilised resource. The potential benefits of full utilization of real estate in transition countries are not sufficiently understood. Accordingly, governments fail to make real estate market development a sufficient priority. It is maintained that if transition governments understood the benefits then they would apply the appropriate level of effort necessary to obtain them.

The purpose of this paper is to highlight some of these benefits. The paper is divided into two different sections. The first section will discuss the benefits to an economy of actually having the end result, namely an active real estate market. The second section will highlight the benefits of engaging in the process that leads to the end result.

A. Benefits of actually having an efficient real estate market

1. Benefits for society as a whole

1.1 The efficient and optimal use of land resources is the principal benefit to be realised from developing real estate markets.

1.2 In most Western countries real estate related activities account for around 25%-30% of all economic activity (or GNP). In the U.S., real estate accounts for 30-40% of all wealth. Notwithstanding the importance of real estate to modern Western economies, there has been a serious lack of attention by both developed and developing economies to the role that real estate plays in a fully functioning market economy.

1.3 Businesses and individuals owning land have a potential source of value. This value can provide capital with which the economy can grow and develop. The ability of an economy to realise this untapped value is directly a function of the effectiveness of their real estate markets.

1.4 For example, in the UK, figures indicate that the amount outstanding of lending to individuals is nearly £700 billion of which £565 billion is secured on dwellings and the remaining £135 billion is consumer credit, most of which is granted against the knowledge of their ownership of property and/or permanent employment that contribute to their credit rating. The majority of this borrowing is fed back into the UK economy either by way of savings and investments or consumer spending.

1.5 The emergence of a market in real estate will also help establish the mobility of labour within a country since people will find it easier to move to centres where jobs are available if they have the ability to obtain housing. Conversely, it could help reduce the economic migration of skilled professionals out of the country to seek available jobs and housing.

2. Benefits for the governments of Central and Eastern Europe

2.1 A functioning real estate market provides a tax base that can be used to fund local and some central services. In many Western countries, many local services, such as roads, schools, and basic infrastructure are substantially financed through property taxes. For the central and local governments in Central and Eastern Europe, the development of real estate markets should properly be viewed as an investment into their long-term prosperity.

2.2 Functioning real estate markets underpin the ability to conform to economic convergence criteria of the European Union. To meet the economic convergence criteria for joining the EU, the countries of Central and Eastern Europe need to establish economic stability and the ability to compete with Western businesses.

2.3 Functioning real estate markets enhance public support for market-based reform. All democratic governments of Central and Eastern Europe understand that political constraints play a major role in the process of economic transformation. Transition has been very hard on the populations of these countries, resulting in much economic hardship. Further, as many market oriented reforms occurred without first establishing the necessary institutional environment for regulating such economic activity against the opportunistic activities of certain individuals, societal support for market oriented reforms is often very weak.

Two transitions are taking place: one to a democratic society and one to a market based economy. In some countries, a third transition is taking place; namely from a developing country to a developed country. When the economic reforms place financial hardships on the local populations at the same time as the societies are becoming more democratically responsive, economic and political reforms can often come into direct conflict. It is this economic/political dilemma that lies at the heart of most difficulty in advancing the market-oriented agenda. Due to the many ‘unintended consequences’ of rapid privatisation without first creating the necessary institutions for governing market activity, local populations are sometimes at best sceptical and perhaps hostile to market oriented reforms.

Housing is a critical issue for the population in judging the success or failure of market oriented reforms. It has been noted by many commentators that the privatisation of housing has been the single largest wealth transfer from the state to the population that has occurred during transition. Unfortunately, this wealth remains largely untapped due to the ineffectiveness of real estate markets.

2.4 Functioning real estate markets will lead to better urban policy. Understanding how land and property is traded in a viable market in real estate helps realize urban development and management of the urban development process. Urban change looks at how the built environment adjusts to changes in demand via the real estate markets. Understanding real estate markets will be critical to a comprehensive understanding of the socio-economic developments that are occurring in Central and Eastern Europe. Understanding the role of real estate markets in urban change will help inform policy makers of the best means of implementing urban policy.

3. Benefits for the citizens of Central and Eastern Europe

3.1 A properly functioning real estate market typically employs a large percentage of a country’s population. A fully developed real estate sector involves and utilises a very wide range of skills and resources.

3.2 A functioning real estate market also provides for increased social equality. A fully functional and decentralised real estate sector spreads the sense of ownership in the economy throughout a large percentage of the population. In many Western economies, real estate ownership is highly diversified, not held in the hands of the State or a few elite. This provides for higher levels of economic equality and opportunity.

3.3 Further, the real estate sector naturally lends itself to self-help and self-improvement. A sense of upward mobility is an important social component for developing an entrepreneurial culture.

4. Benefits for business and investors

4.1 Real estate is the physical precondition for all economic activity. All business, even e-businesses, requires physical space to conduct their economic activity. It is not sufficient to simply have space, but for maximum efficiency the space needs to conform to the business needs. A developed and mature the real estate market is best able to provide the optimal physical space for this economic activity.

4.2 Functioning real estate markets also facilitate and attract foreign direct investment. This is a critical development. There are two levels at which this happens. At an initial level, well functioning real estate markets attract foreign capital (for example, in the form of lines of credit to local Financial Institutions for onward lending and to purchase real estate assets). To attract foreign investment in real estate, the risk/returns ratios in the countries of Central and Eastern Europe must be competitive with the rest of the world. For large institutional investors, the high degrees of uncertainty associated with ownership, investment climate, risk of seizure, etc., may make many countries of Central and Eastern Europe simply 'too risky'. Despite high returns in some areas, when the risk reaches a certain level the asset becomes part of another type of investment which excludes most institutional investors.

4.3 There is a second dimension in which functioning real estate markets help attract foreign direct investment. When a foreign firm is evaluating whether or not to enter a country, there are three major questions: what are the costs of entry? What are the profit possibilities while there? What are the costs of exit? The extent to which there is a functioning real estate market significantly and directly affects all three.

4.4 Further, functioning real estate markets facilitate the development of financial markets. A real estate lender is first and foremost an investor. Like any investor, they will only commit funds where the expected return is sufficient to justify the risks. Since mortgage lenders are a non-controlling investor in real estate assets, in other words they have no direct management control of the asset, the only security they have on their loan is the asset itself. The value of the asset to the lender is fundamentally dependent on its resale value if foreclosed upon. If the real estate markets are not functioning well, then the lender will reasonably apply a steep discount to how much they will be able to recover upon foreclosure. The lower their expected recovery value, the lower the loan to value ratio they are willing to offer. The lower the loan to value ratio, the more difficult it is for investors to make real estate purchases to begin with.

5. Benefits of engaging in the process of developing real estate markets

5.1 The above describes what are essentially some long-term benefits of the establishment of a viable market in real estate. An equally important question is what are the short and medium term benefits of developing real estate markets?

5.2 It is important to recall that a real estate market is not an end-state, but rather is an ongoing process of greater and greater levels of market maturity. The benefits are not discrete 'haves' or 'not haves', but are rather incremental. Each benefit described above is incremental in nature. In other words, the more a country's real estate market is developed the more it can enjoy each of these benefits. With each improvement in the market, the more complete will be the benefits. So each benefit listed above is likewise a benefit to be realised in the short or medium term, just as at a more incremental level.

B. Benefits of engaging in the process

6. Developing real estate markets greatly accelerates the transition to a fully fledged market based economy

6.1 Developing real estate markets increases the need for market-based institutions. The participants within a certain institutional framework and the institutional framework itself mutually affect one another. By changing the institutional structure, the participants are changed; and likewise by changing the participants the institutional framework is changed. Market institutions depend upon the demand for them. By changing the institutional framework the countries of Central and Eastern Europe can change the way participants think and act, which continues to change the institutional structure, and so forth. Further, by developing real estate markets, new participants are introduced into the economy that likewise increases the demand for market-based institutions.

6.2 Developing real estate markets creates a large entrepreneurial/risk-taking class. Brokers, mortgage bankers, developers, construction firms, and handymen can all be empowered through the development of real estate markets. A strong entrepreneurial class can change the way the markets and the society are governed by helping shape public attitudes towards the market economy.

6.3 Additionally, developing real estate markets leads to the creation and development of small and medium sized enterprises (SME's). Small business owners and an entrepreneurial class are the key to a vibrant market civil society that grows from the bottom up. For example in Poland, most of their growth has come from SME's, not from large firms. SME's are the main employers in mature market economies.

For example, in Italy the total percentage of the population employed by SME's is 73% and contributing 58% to the National GDP. In Russia, the equivalent figures are 13% and 11% and in Kazakhstan 5% and 6%.

7. Developing real estate markets creates the institutional preconditions for economic growth

7.1 The characteristics of successful economic development are generally known. The problem is how to attain the development of these characteristics. Economic growth occurs when the institutional environment provides incentives for increased productivity in the factors of production. Inappropriate institutionalised incentives, such as redistribution, corruption, "tunnelling", etc., can encourage unproductive activity. Productive activity, such as innovation, greater efficiency, better service to the client, market competition for customers, investments in human and physical capital, can be encouraged by institutional incentives. This is the recipe for continued economic growth and prosperity, as is evidenced by the developed Western economies and those transition countries who have similar incentive structures.

7.2 The key institutions that bring about these productive oriented incentives are a stable political structure, and a system of law that is transparent, reliable and enforceable through an independent judicial system. If these key characteristics exist, then well-specified and enforceable property rights can become established. This process in itself helps to embed the key stabilising characteristics of a mature economy leading to economic growth and prosperity. Specifically, developing real estate markets increases the demand for market oriented political structures, requires well-specified and enforced property rights and low cost enforcement of contracts. Thus, by investing in the requisite institutions that help develop real estate markets, indirectly the institutional foundation necessary for economic growth and prosperity is also encouraged.

8. Developing real estate markets liberates a new source of capital

8.1 The second major way that the development of real estate markets leads to greater economic growth is through an increased proportion of 'market-mobilized capital.' Real estate assets perform two functions. The first is the immediate visible usage for living, working, and so forth; the second is its 'parallel life' of securing third party interests and providing capital for investment and consumption. In many transition countries, most of the real estate assets remain outside the formal property system, either through lack of clearly defined property rights, non-recorded or non-existent property records, or through tolerated unauthorized occupation of land. Because these assets are not part of the formal property system, an 'owner' cannot clearly demonstrate 'ownership' in a legal sense, and as a result the 'asset' cannot be used for securing liquid 'capital' in the form of a loan. This means that the growth of small and medium sized enterprises – generally regarded as critical if economic growth for economies in transition is to be established – will be severely limited because they lack capital.

8.2 As is the case in the West, functioning mortgage markets can provide a solution to this lack of capital.

The single most important source of funds for new business in the U.S. is a mortgage of the entrepreneur's house. These assets can also provide a link to the owner's credit history, an accountable address for the collection of debts and taxes, the basis for the creation of reliable and universal public utilities, and a foundation for the creation of securities (like mortgage backed bonds) that can then be rediscounted and sold in secondary markets. By this process the West injects life into assets and makes them generate capital. (Hernando de Soto, *The Mystery of Capital,* 2000)

8.3 So how much untapped capital exists? The magnitude of this untapped capital is astonishing. Hernando de Soto, in his book *The Mystery of Capital*, estimates that the total value of this untapped capital in former communist countries is $2.96 trillion (de Soto, 2000). This is equivalent to 66% of U.S. circulating money supply; a third of the total value of all the companies listed on the main stock exchanges of the worlds twenty most developed countries; about seven times the total foreign direct investment into all third world and former communist countries in the ten years after 1989; fifteen times as much as all the World Bank loans of the past 30 years, and thirty times as much as all the development assistance from advanced countries to the third world for the last 30 years.

Leaders of the Third World and former communist nations need not wander the world's foreign ministries and international financial institutions seeking their fortune. In the midst of their own poorest neighbourhoods and shanty towns there are -- if not acres of diamonds -- trillions of dollars, all ready to be put to use if only we can unravel the mystery of how assets are transformed into live capital. (de Soto, 2000)

8.4

So what is the benefit of being able to access all this capital? There is a strong econometric link between the amount of 'market-mobilized capital' and economic growth. Econometrically, the link between the development of mortgage markets and economic growth is well established. Azfar (1999) found that an increase in the amount of market mobilized capital increases economic growth. Analysis of regressions of the rate of economic growth on the degree of market mobilized capital (debt and equity) for 40 different countries of various income levels shows that a two standard deviation increase in the amount of market mobilized capital increases the economic growth rate by 1.3% (which is enough to shorten the amount of time it takes to double per capital GNP from 70 to 30 years). In most developed countries, real estate represents about 25% of all wealth. In transition countries, real estate represents only about 2%. The opportunity for substantial economic growth, based on the use of land, as an asset traded through a viable market in real estate, is obvious. If only a small fraction of the $2.97 trillion were mobilized into the market, it would have a profound impact on the rate of growth.