

**An Excerpt from**  
***A Roadmap for Housing Policy Reform in Egypt: Developing a  
Well Functioning Housing System and Strengthening the  
National Housing Program***

**Section on the *Impact of Rent Control and  
Rental Housing Reforms***

**Prepared for the Government of Egypt**

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*A Roadmap for Housing Policy Reform in Egypt* was prepared by a joint team from the World Bank Group and the United States Agency for International Development (USAID)'s Technical Assistance for Policy Reform II (TAPRII) project in 2007. The team was comprised of Sameh Wahba (Senior Urban Development Specialist and Task Team Leader, The World Bank), Marja Hoek-Smit (Housing Finance and Subsidy Consultant, The World Bank), Catherine Lynch (Urban Development Consultant, The World Bank), Sally Merrill (Housing Consultant, Urban Institute, TAPRII), Hans-Joachim Duebel (Housing Consultant, FinpoConsult, TAPRII) and David Sims (Housing Policy Consultant, The World Bank). **This section on rental housing was primarily prepared by Hans-Joachim Dübel, Finpolconsult.**

## INTRODUCTION: EGYPT'S HOUSING STOCK MANAGEMENT PROBLEMS

*Much of Egypt's housing stock still remains constrained by very high vacancies, rent control, and informality.* A summary of main issues is as follows:

- (i) *Almost 3.7 million housing units are unused, either vacant or closed.* According to the 2006 census, the total number of unused units in urban areas in Egypt reached 4.58 million units, of which 1.18 million were closed and 3.40 million were vacant. Due to the lack of detailed breakdown by unit use in the preliminary census results made available by CAPMAS, it was estimated that 3.72 million or 81.3% of these 4.58 million unused units are for housing use, while the remaining 18.7% are for work use (commercial and office space in mixed-use buildings, housing units informally converted into office space, etc).<sup>1</sup> The scale of vacant urban housing units, much more serious than in other emerging markets, is a specific and puzzling phenomenon of the Egyptian housing market. One explanation is that the sustained rapid appreciation in value over the past 25 years or so and the lack of alternative investment mechanisms until quite recently meant that housing and real estate have consistently served as an inflation-proof savings and investment mechanism, without need of the rental yield.<sup>2</sup> The idea of renting was even less attractive due to the imposition of rent control until 1996. Even now, the continued perception of uncertainty about the enforceability of the new rental law makes many owners hesitant to put their unoccupied units to rent. Poor targeting of government subsidized units, as well as the mostly unattractive locations in New Towns, have also further exacerbated the problem.
- (ii) *An estimated 42% of the housing stock is frozen under rent control.* Since the passage of Law No. 4 of 1996 that freed the rental market for newly built and the then-vacant units, but grandfathered existing rent-controlled units for the duration of the contract, the rental market is showing signs of much dynamism. The TAPRII Greater Cairo Housing Demand Survey found that 81% of all the new units accessed in the 2001-2006 period were through rental contracts signed under the new law (only 19% were for ownership). Yet, the TAPRII survey also indicates that 42% of the total urban housing units in Greater Cairo are still locked under the rent control regime as a result of grandfathering, and that this is not necessarily benefiting the poor. This greatly constrains residential mobility, locks a large proportion of units out of the market, causes lack of stock maintenance, and distorts the overall housing market.

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<sup>1</sup> This estimate is based on the fact that of the 9.74 million occupied units in buildings in urban areas (excluding work and official establishments), 81.3% or 7.91 million units were used for housing and 18.7% or 1.82 million units were used for work. The assumption therefore is the breakdown of unused (both vacant and closed) units would follow the same distribution between housing and work uses.

<sup>2</sup> Despite some slowdown in the early 2000s, this trend has continued unabated and has very recently reached new heights, fuelled by major inflows of foreign investment in real estate in Egypt from regional investors.

- (iii) *Some 45% of new urban housing is produced by the informal sector.* During the inter-census period (1996-2006), the urban housing stock is conservatively thought to have grown by an annual average of 2.8% or 263,838 units (9% higher than the annual average for the previous inter-census period 1986-1996 where the average was 241,916 units).<sup>3</sup> Of these, 55.6% were formal and 45.4% informal. Constrained by high building and zoning standards, as well as a bureaucratic and costly permitting process, many small developers operate within the informal sector to meet the growing needs of lower income households.

*The main challenge today is to devise affordable housing policies and strategies that address the distortions that to date constrain the housing market from functioning efficiently.* The first critical steps in this regard were the abolition of the rent control legislation in 1996, after five decades in which it severely distorted the housing market, and the creation of the regulatory and institutional frameworks governing housing mortgage finance. The key remaining challenges that the new affordable housing policy will need to address are to: (i) put in place the institutional frameworks and incentive structures needed to enable an expanded private sector role in the financing and delivery of affordable housing; (ii) rationalize the subsidies provided to limited-income groups by eliminating off-budget subsidies and developing efficient targeting instruments; and (iii) ensure the development of a viable rental market to serve the needs of the lowest income groups in conjunction with some homeownership opportunities.

## ENHANCING RENTAL MARKET REGULATION

*In a recent UN assessment of rental housing in emerging markets, Egypt was highlighted as a good example of rental market regulation reform.* Indeed, since the passage of Law No. 4 of 1996 that liberalized new rental contracts, the rental market is showing signs of dynamism. According to the TAPRII Housing Demand Survey, the decontrolled rental sector has absorbed more than 80% of new housing acquired during the 2001-2006 period. Thus, the new law has central importance for catering to the housing demand of the young and mobile in Egypt. Additionally, the new law rent-burden levels recorded by the TAPRII Survey for Cairo average 23.3% of income. This is similar to rent burdens recorded internationally for large cities. Since many new law tenants are young and have relatively low incomes, this rent burden level may even be considered to be in the low end of the range. It is likely, moreover, that the new law has improved efficiency in the housing sector by increasing housing stock turnover through lower contract durations. Nevertheless, many consider rent levels as high and volatile, and rent adjustment mechanisms as not well defined. Also, key

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<sup>3</sup> The preliminary results of the 2006 census made available by CAPMAS do not allow for a precise calculation of the number of housing units. As such, the total number of housing units in urban areas was inferred as the sum of “apartment units” (shakka) and “one/more independent rooms” (hogra mostakela). This figure is counter-balanced by the exclusion of single family housing and the failure to account for housing units converted into offices.

money has not disappeared. Many rental contracts are still informal and provide the tenant little protection, such as against arbitrary terminations after a sale or during modernization.

*The use of term contracts (between 2 and 5 years) as default could increase tenant protection without seriously compromising the rent setting capacity of the landlord.*<sup>4</sup> After decades of rent control and very long-term leases, Egyptian tenants are adjusting to shorter rental contracts practiced under the new law. However, according to the TAPRII Survey, tenants still desire tenure security in the form of longer-term rental contracts. The 1996 law does not provide for a “default” tenure which – if matched to current typical market terms of 5 years – might generate a greater sense of security. It would seem that rental law should define such a term contract as the default (i.e. when no contractual provision says otherwise; the term of the default contract could be 2, 3, or 5 years), since it would allow a reasonable compromise between tenure and rent level security for consumers on the one hand and rent-setting ability and flexibility to dispose of the housing asset for the landlord on the other hand.

In the case of term contracts, roll-over is the standard going forward: when the initial term ends, the landlord either gives notice or the same term will be automatically renewed (as is practiced in Spain). Less preferable are term-to-permanent roll-overs (Brazil) since they might lead to ‘accidental’ permanent contracts. Clearly, options for agreeing on short-term leases should be kept, for example, if the landlord foresees alternative uses for the property in shorter time. Also, conditions for permanent, or indefinite, rental contracts should be defined. Special termination options for the landlord and tenant would need to be legally defined both in the case of term and permanent contracts; however the necessary minimum is much less comprehensive for a term contract, which reduces the likelihood of litigation.<sup>5</sup>

*Rent setting and adjustment mechanism are directly related to the contract term.* Within term contracts, indexation or rent escalators are adequate mechanisms for adjustment, if needed at all. Critical are the conditions for changes in rent levels *after* a term contract renewal.<sup>6</sup> A reference system, as described in Box 1, is here the preferred yardstick, as for the setting of new contracts and adjustment in permanent tenure contracts. The reason is that, for example, CPI indexation in a permanent contract or as term contracts are rolled over may generate a large risk of mismatch with housing market conditions, which burden either landlords or tenants. Moreover, pervasive indexation raises macroeconomic stability issues.

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<sup>4</sup> The analogy, again, is 5 year fixed-rate mortgage which is a compromise between security and costs.

<sup>5</sup> For example, in a 2, 3 or 5 year term contract the law will arguably not give a landlord the option to evict for an own use of the unit (e.g. for use by his children). However, such an option would have to be given in a permanent rental tenure situation in order to render renting economically feasible. The British rental reforms of 1988 for example thus differentiated the law between Term and Assured (permanent) tenancies.

<sup>6</sup> The economic problem is not different from a short-term adjustable-rate mortgage borrower facing interest rate risk.

### **Box 1: Reference Rent System - Principles**

- Reference rents derived by regular empirical surveys within a given city. Price indexation is used only for updating, if surveys are undertaken infrequently.
- The survey covers all rental contracts closed in the past 3-5 years in order to smoothen out short-term market movements.
- The survey results in average rent and confidence band quotes over a tridimensional (quality-size-location) matrix.
- Legally, the rent survey can be a basis for usury rules and court decision-making, e.g. if individual rent exceeds the average by 20-25%.
- A low-cost alternative are regular expert rent surveys.

Rent increment caps could be defined in order to reduce default risk due to payment shocks. As an example, the Spanish limit is 20 % per annum; possibly in a higher inflation scenario limits should be at 25-30%. Rent increases after comprehensive modernizations warrant a set of principles, and there are various options. In the Spanish case, rents can be increased by the amount of investment times a regulated interest rate. Germany amortizes the amount of investment in the new rent over 10 years.

*Historically, eviction of a rental tenant is a lengthy process in Egypt, reportedly taking up to three years.* Recent amendments to Law No. 4 of 1996 introduced provisions which benefit the landlord under new contracts. An important one is that agreements notarized in the presence of the contracting parties may operate as enforcement orders such that landlords are no longer required to have recourse to the courts to enforce tenancy agreements. These provisions do not pertain to agreements governed by the old rent law however. In addition, in the mortgage sector, Egypt already has embarked on an eviction enabling program, including both a new law and a training program for judges. This approach could be expanded to rental properties. Streamlined court procedures or extra-judicial procedures have proven to be important elsewhere. In Colombia and Brazil, for example, rental eviction case durations have been reduced within a decade from several years to 3 to 6 months. Additionally, a local ombudsman system for mediating tenant-landlord conflicts below the court level is today mandatory in a number of jurisdictions, including Colombia and Spain. Rent setting conflicts could be deferred to the local property tax valuation committees or local government housing offices, once rent setting rules are properly defined (see below).

*An interesting program option for Egypt could be a public eviction guarantee for social tenants accepted by private landlords.* Eviction in housing is an option de-facto determined by government activity, which sets legal eviction rules, defines court procedures and determines the availability of substitute housing for evicted tenants that usually interacts with a court's willingness to spell out an evict order (e.g. for a family). Asking rental landlords, which are often households or small firms, to de-facto provide such substitute housing is hugely inefficient and tends to eliminate rental housing supply. In developed economies, the public housing stock provides such substitute housing.

A lower-cost alternative for emerging markets, next to some public emergency shelter, could be a locally managed pool of private rental landlords offering lower quality (and cost) units, which are affordable for an evicted tenant or, if necessary, fully coverable by public rent allowances. Clearly, such a proposal carries considerable fiscal risk and should be enabled only once lease registration and streamlined eviction processes are in place. Also, certain groups in lesser need for protection (e.g. young, non-families) can be excluded from the guarantee. It requires local government initiative to define and manage the substitute housing stock, or equivalently roaster of private landlords.

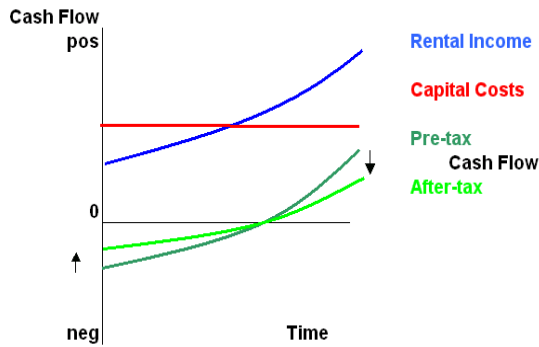
*A registration system for leases, as practiced in Brazil, could have considerable advantages for Egypt.* The benefits for landlords consist in access to clear and streamlined conflict settlement and contract enforcement procedures. The benefits for tenants include the protection against eviction in the case of house sale or comprehensive modernization, and other legal protections in conflict. The GOE would need to play the main role in setting up the system and assume all costs. Registration fees should be low to maximize enrollment incentives, and the process needs to be a simple one (arguably a registration by deposition at Real Estate Publicity Department). As a pay off, however, the public sector could expect greater levels of tax formality in the rental sector as well as significant revenues from the currently informal sector.

*An unfavorable rental tax regime may be thwarting the effort to open vacant units for rental use, as well as causing widespread informality of rental contracts.* It is believed that the large majority of Egyptian rental investors pay currently no income or property taxes for their rented units. Formal property tax liability for example mainly applies to the 20% of new law contracts and a few old law contracts where rents exceed a minimum tax threshold of LE 10 per month. De-facto all the rent-controlled housing stock is tax-exempt. Moreover, local property tax evaluation committees tend to severely under-assess gross rental revenue.

Going forward, the incidence of rent control will be reduced and more contracts become formally tax-liable. An unfavorable tax regime, at least for non-corporate investors, in which income taxes on rental property are paid largely independent of the net income on the unit, is likely to keep discouraging greater formality levels. The tax base is currently defined as 50% of gross rental income, with no additional deduction possible for the higher costs of comprehensive modernization of the unit. The tax rate is up to 20%, which means that rents are de-facto subject to a flat 10% tax, reducing landlord profitability regardless of the actual profit level. Figure 5 provides intuition of these mechanics.

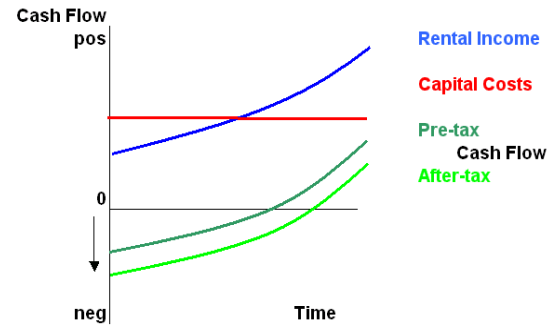
The property tax reform that is currently underway includes a proposal intended to arrive at a 10% tax rate with a tax base of 15% of gross rental revenue. This new scheme would translate into an additional 1.5% mark-up to the 10% gross revenue income tax, deepening the financial disincentive to formally register and rent an unoccupied unit.

**Figure 1: Rental Investor Cash Flow Profile with Cost Deduction (Investment Good Model)**



Source: Finpolconsult.

**Figure 2: Rental Investor Cash Flow under Gross Rental Taxation (Current Situation)**



*It is recommended that an investment model of taxation be used for individual landlords.* This could be implemented in a straightforward manner by adding a single sheet to the income tax declaration dealing with revenues and costs of investment property. Deductible expenses should include maintenance and repair costs, interest paid on mortgage loans taken to finance the investment, and economic depreciation. The resulting losses in initial investment situations can be contained, for example, by imposing maximum eligible per square meter investment costs. However, this and similar measures should leave sufficient degrees of freedom for investors, for instance investment cost ceilings could be indexed with construction costs. Since the majority of Egyptian landlords do not possess large property portfolios, the provision for pooling losses derived from initial rental losses with other sources of income like salaries or business will be necessary. Again, limits could be imposed to contain losses (e.g. positive total net income). Finally, investors should be able to carry losses from rental investment forward to future incomes.

*In summary, it is recommended that Egypt move toward a revised framework for tenant-landlord relations.* The revised system would include: (i) tenant protection standards for all tenancies covering inter alia minimum default contract term, lease termination and rent-setting rules; (ii) a registration system to formalize leases (for both consumer protection and taxation purposes), (iii) mandatory mediation prior to court action, e.g. through local ombudsman or property valuation committees; (iv) consumer, landlord, and judicial education regarding the revised rules; and (v) a streamlined rental eviction processes (in parallel to the ongoing initiative in mortgage finance) and consideration of a public eviction guarantee for PPP housing programs.

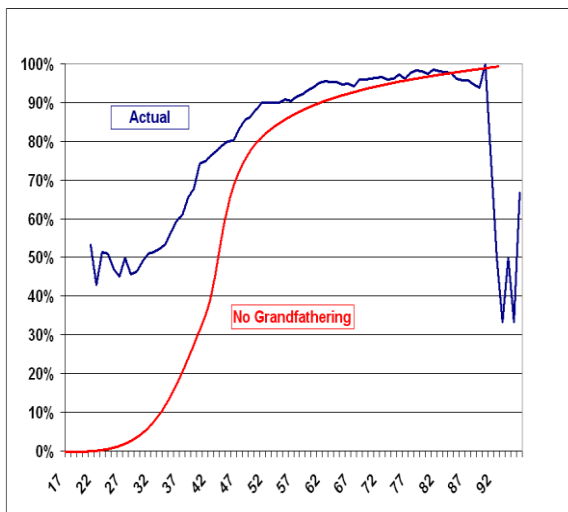
The successful Spanish reforms would suggest that a well-designed tenant-landlord relation framework leading de-facto to a 'soft' rent control system could buy the political support for the necessary acceleration of 'hard' rent decontrol. This specific issue is addressed in the following section.

## ACCELERATING RENT DECONTROL

*The series of rent control laws imposed by the GOE as early as 1944, but especially during the 1950s and 1970s, has had serious effects on the housing market in Egypt. Rent control was originally conceived as a temporary measure in the aftermath of World War II; it was later extended to preserve housing affordability for limited income groups. Rent control forced housing investors to concentrate solely on building housing for sale, which implied a focus on the upper income segment of the market. Professional long-term investors in rental housing, such as insurance companies, exited the market facing severe losses on their existing holdings. At first, rent control law applied only to units built during the 1940s, but controls were gradually extended and applied to all new construction (i.e. no targeting).*

*Renting is tantamount to owning, for the insiders. Rent control prompted the application of key money for new rental contracts or to release an old rent-controlled agreement. A comprehensive World Bank study on the rental sector in Cairo found that, in practice, key money is roughly equivalent to the net present value of the difference between market rent and the frozen rent level over the duration of a long-term tenancy contract.<sup>7</sup> In effect, renting has been tantamount to owning in Egypt, and households expect to have – and have had – exceptionally long leases relative to most other rental markets worldwide.*

**Figure 3: Share of Old Law Tenants by Age Group**



Source: Finpolconsult based on TAPR II Survey data.

*Bequeathing rules create new generations of insiders and perpetuate distortions. The 1996 law grandfathered existing rental contracts, thereby allowing units to be passed on one time to a family member (parent, spouse, offspring, or any relative of the first degree) living in the household 2 years prior to the death of the tenant. Indeed, this provision, although not uncommon for rent decontrol in its first phase, is frequently abused. A typical form of abuse seems to be children, or even grand-children, moving into the apartment shortly before the anticipated deaths of parents or grand-parents, just to comply with the letter of the law. Anecdotal evidence about more serious infringements*

*includes the changing of residence on the government issued identification card and the name on household utility bills to prove occupancy. As a result, about 50% of tenants in the age group 25-35*

<sup>7</sup> Hardman, A, Malpezzi, S. and S.Mayo. 1995. "Egypt Rent Regulation Reform Study for the Arab Republic of Egypt". Study commissioned by the World Bank. Cairo.



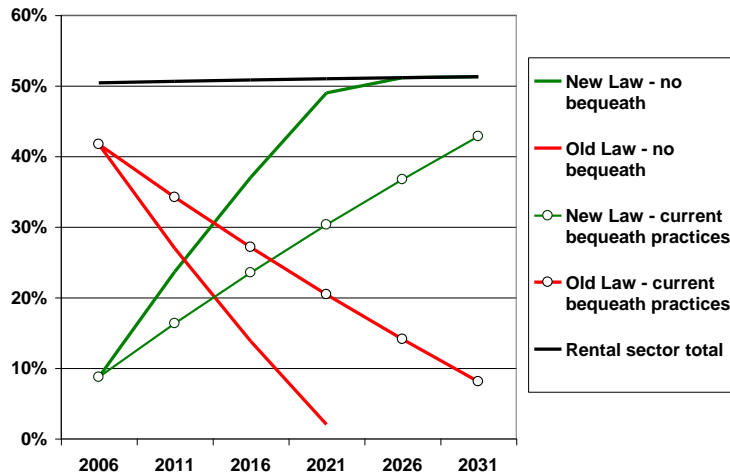
years (household heads) are living in controlled stock, paying rents usually not exceeding 5% of stated household income (Figure 6).

*Going forward, without further action, the rent-controlled sector will remain for another three decades.* As Box 2 details, the current situation of massive bequeath of old rental contracts to the younger generation will likely leave Egypt with a large part of its housing stock under rent control for a long period. A simulation presented in Figure 7 suggests that it could be three decades. Even a radical reform scenario in which bequeath would be prohibited altogether would still mean that Cairo had a rent-controlled sector of 14% of the housing stock by 2016 (Figure 7).

### Box 2: The Cost of Doing Nothing to the Rent Controlled Sector

In 2006, already 10 years into the new law, 41.7% of the TAPRII surveyed housing units in Greater Cairo were still under rent control and only 8.7% were non-controlled (i.e. 83% of the rental stock). It can also be inferred from the survey data that about 50% of the old rental contracts are bequeathed to the next generation, for whom both mortality rates and conversion or termination incentives will remain low over the coming decades. Given this constellation, terminations of old law contracts with subsequent closing of new law contracts are unlikely to reduce the old rental stock by more than about 5-6% (referring to total housing stock), within a 5 year period. In other words, at the current conversion pace it would take more than 30 years to eliminate the rent controlled sector in Greater Cairo. By 2021 almost 21% of the housing stock would be under rent control, half of the current controlled stock. Even a radical reform scenario in which bequeathing was prohibited altogether (as was de-facto implemented in Spain in 1994) would mean that Cairo would still have a rent-controlled sector of 14% of the housing stock by 2016, and about 5% by 2021.

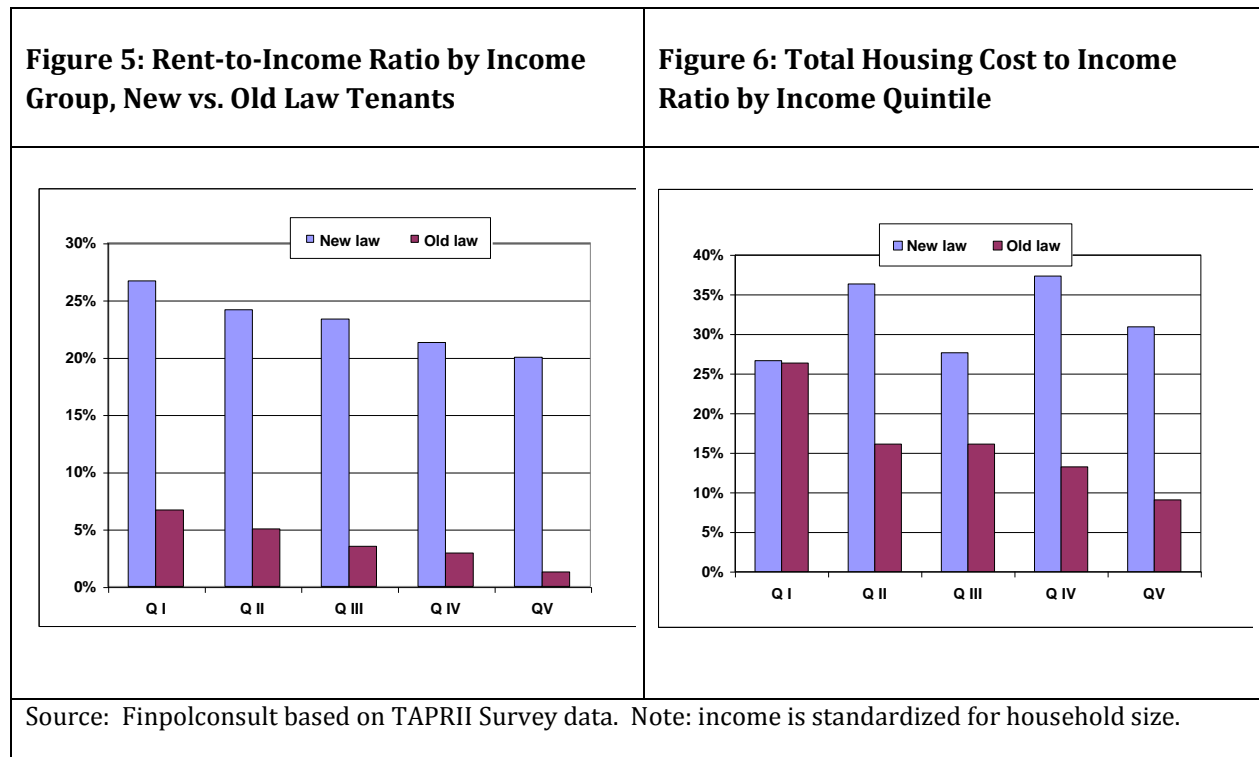
**Figure 4: Permanence of Rent-controlled Old-law Stock in Cairo under Current Bequeath Practices and Bequeath Prohibited, % of Total Cairo Housing Stock**



Source: Finpolconsult based on TAPR II Survey data.

Note: Forecast uses demanders survey data, assuming that 80% of new rental contracts closed during 2001-2006 were old rental contract conversions/terminations and 20% from other sources (vacancies/new construction, other). Forecast does not use explicit mortality table for bequeathing tenant generation.

The cost differences between controlled and non-controlled rent contracts are considerable. Since tenancy changes in old law contracts usually come with the payment of key money, it has been claimed that average rental payments in greater Cairo – considering foregone interest on key money – do not differ substantially from market conditions.<sup>8</sup> However, the majority of old law tenancy changes seem to be intra-family, where key money payments are unlikely or at most in-kind.<sup>9</sup> Moreover, marginal rental payments (i.e. for a current tenant facing the choice to move or stay) certainly differ, since key money is usually payable to the landlord and non-recoverable in the case of a move. This means that mobility decisions are highly affected. Figure 8 indicates rent-to-income ratios by income quintile for old and new law tenants for the TAPRII Survey households.



Total housing costs differ from rents for poorer households. Tenants under rent control in Cairo generally pay third parties for services that the landlord would usually provide, or whose costs would be passed through in the rent. These charges are for capital repairs, sewerage and water services, and even real estate taxes. The total of these payments, together with rent provide an estimate of total housing costs. The results indicate that differences between old and new law tenants narrow systematically for poorer households, but not for higher income tenants. In the first income quintile, for example, the rent-to-income ratio under the old law is only 7% while the housing cost-to-income ratio is 26%, comparable to new law rent burdens. For tenants in the fifth

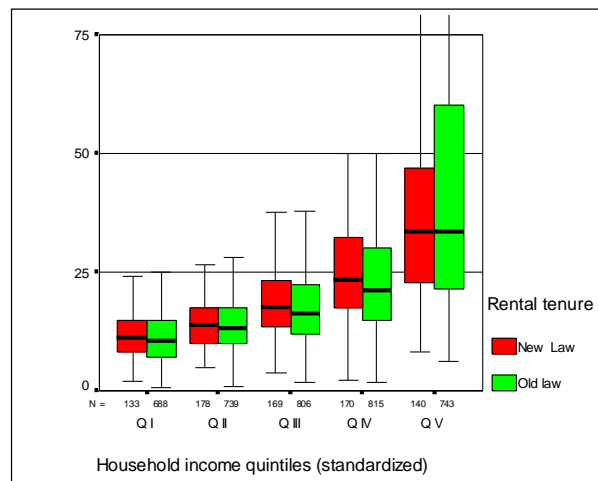
<sup>8</sup> Hardman, Malpezzi and Mayo (1995)

<sup>9</sup> Unfortunately the TAPRII survey did not record the level of key money paid separately.

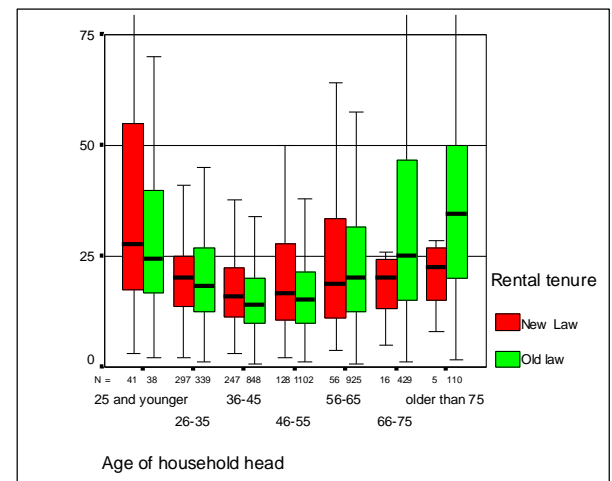
income quintile the housing cost-to-income ratio under the old law still barely exceeds 9% while the rent burden under the new law is 20%.

*Ongoing rent controls will create efficiency losses for the labor and housing markets.* The rent differences provide a powerful incentive to extend old rent law contracts and reduce mobility. Indeed, the mobility indicators derived from the TAPRII Survey are very low by international standards (roughly 1% of families in Greater Cairo relocate per year, compared to 2-5% in other developed countries, urban *and* rural). Since under the old rent law, many households pay far less for housing and controlled housing is concentrated in valuable inner city locations, unavailable now for higher value uses, this means also a distortion of the overall housing and land market. Rent control moreover impacts public infrastructure investments (via reduced property tax payments) and reduces comprehensive modernization investment activity. Repairs and other smaller investments may be covered by the tenants through the mentioned side payments, although possibly not sufficiently. For the same reasons, young tenants in the rent-controlled stock will be extremely unlikely to become mortgage borrowers - financing a newly constructed unit on a newly serviced piece of land sold at the market price means multiplying monthly housing costs.

**Figure 7: Housing Consumption of Old Law Age Group of Tenants by Income Quintile**



**Figure 8: Housing Consumption by Head of Household**



Source: Finpolconsult based on TAPRII Survey data.

Note: Box contains central 50% of observations (25%-75% of distribution), fat black bar represents median (50%-value of distribution).

*Excess housing consumption is usually a companion feature of rent control and for Greater Cairo this can be detected among the elderly and richer households.* In the case of the richest households in the fifth quintile, 50% have over 33 and 25% have over 61 square meters per person. Similarly, many older households occupy large spaces, certainly partly with an eye on bequeathing them to the next generation. The bequeathing motive apparently also makes subleasing by the elderly unpopular, a common feature in rent control environments elsewhere. Finally, while the impact on vacancies

cannot be observed in the TAPRII Survey data, but the low rent levels are likely to contribute to high vacancy rates. With a nominal monthly rent level of on average LE 34.5 (instead of LE 230, the market rental value), a person with an old law lease could have more easily chosen to hold on to his unit for future use by living elsewhere and keeping the unit closed or vacant for his children or for future investment. Analysis for Sao Paulo has shown that the rent decontrol act of 1991 enhanced the supply especially of small, low-cost rental units. Supply came almost entirely from units held vacant before the passing of the law.<sup>10</sup>

*The TAPRII survey data analysis yields several conclusions on the distribution function of rent control.* First, virtually no affordability redistribution ('vertical equity') of the rent control system can be detected. The rent-to-income ratio under the old law is lower for all household income strata, including the richest. Second, the poorest households have higher rent-to-income ratios and total-housing cost-to-income ratios in both cases, old and new rental law. Because of additional non-rent housing costs poorer households pay a substantial portion of income on housing, even if they are under a rent controlled contract. Third, the main beneficiaries of rent control in terms of rent differences are richer and older households, with considerable overlap of the two groups, especially in central Cairo. The highest income old law tenants consume more space than under the new law, and older tenants under the old law also consume much more space. Fourth, and most importantly, rent control distorts the 'filtering chain', i.e. the process of vacation of lower quality (usually rental) units by higher income tenants moving into higher quality (usually ownership) units. The interruption of the moving chain severely reduces housing supply for low-income households.

*The rent control regime has also no systematic social safety net function e.g. for families with children.* A household type analysis of the TAPRII Survey data (Table 4) reveals that single parents are strongly overrepresented in rent-controlled apartments. This seems to indicate social consensus, if not the law, that the partner who is not raising the children – usually the male – leaves the unit after a divorce.<sup>11</sup> Extended families are also strongly represented, with grandparents typically being the tenant. In contrast, nuclear families, usually young and with small children, are strongly underrepresented. Singles are overrepresented in rent-controlled stock: these are often elderly (and potentially socially vulnerable), but in many cases also young singles occupying an inherited rent-controlled unit.

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<sup>10</sup> Source: unpublished research undertaken for the World Bank in 2006 by Eduardo Rottmann, consultant for the Housing Finance Business Group.

<sup>11</sup> Also, the reverse causality – with the availability of a low-cost unit simplifying a divorce – should be considered, especially in the light of a high share of single parents found in the total sample.

**Table 1: Representation of Old and New Law Tenants by Household Type in the Greater Cairo Region**

	Old law		New law		Old/new ratio	Tenants % of population
	tenants % of	population	tenants % of	population		
<b>Families</b>						
Single parents	90.4%	52.1%	9.6%	5.5%	9.4	57.7%
Nuclear families	80.4%	38.9%	19.6%	9.5%	4.1	48.4%
Extended families	87.7%	51.0%	12.3%	7.2%	7.1	58.1%
<b>Non-families</b>						
Couples, no kids	79.6%	39.7%	20.4%	10.2%	3.9	49.9%
Extended no kids	83.5%	47.8%	16.5%	9.4%	5.1	57.2%
Singles	87.7%	43.6%	12.3%	6.1%	7.1	49.7%

Source: Finpolconsult based on TAPR II Survey data. Note: tenants = private sector only.

*International experience suggests several lessons for approaching rent decontrol.* First, residential and non-residential rent controlled stock should be treated differently, with rent setting in non-residential stock being left to the market. Second, rent adjustments within the residential stock should be introduced gradually to converge toward market rents in a two-step approach of rapidly covering operating cost at first followed by quid-pro-quo rent adjustments against landlord investments. This gradual escalation should subsequently be followed a benchmarking systems of contracts to typical market rent levels, e.g. via market surveys (reference rate system) or indexation.

*A faster pace of decontrol is not only necessary, but also feasible.* The closest analogy to Egypt appears to be Spain, which, like Egypt, started reforming its severely controlled stock in 1984 by completely decontrolling new contracts while keeping all earlier contracts under rent control. Transfer of contracts between the living, however, was banned and bequeaths were limited to two generations.<sup>12</sup> The initial reform phase was characterized by a coexistence of high and volatile rent levels in the liberalized market segment and token rents in the controlled units.<sup>13</sup> In 1994, a second reform law was thus promulgated with two main thrusts. First, it reformed the legal framework for liberalized contracts to provide greater tenure security, which would eventually result in a unified approach for all contracts (see Section 2.0). Secondly, they began de-grandfathering the previously controlled contracts. The de-grandfathering strategy used in Spain was multifaceted. For very old contracts (closed prior to 1964) the right to bequeath was conditioned on the tenant accepting an increase in rents to a level capturing foregone inflation. Alternatively, a tenant could forgive the right of bequeath and keep the old rent level. For all other contracts closed prior to 1984 the right

<sup>12</sup> Including cases in which such bequeaths had already taken place once or twice.

<sup>13</sup> For an empirical review, see Eastaway and Varo (2002).

to bequeath became limited to one generation, to first degree heirs only, and for them only up to the age of 25 or two years after the death of the tenant, whichever comes later. This effectively meant discontinuation of bequeaths. For all contracts, also, a mechanism to raise rents to a level capturing foregone inflation since the introduction of controls was established. If the tenant was a socially vulnerable household (under 3.5 minimum wages) unable to afford these rent levels, the landlord became eligible for a tax support scheme. A reform program inspired by the Spanish experience is about to be implemented by the Kingdom of Morocco, under a World Bank program. Liberalizations with parallels to the Spanish approach have also taken place in Latin America (e.g. in Brazil in 1991 and in Colombia in 2001).

*Other interesting rent decontrol mechanisms can be found in the former socialist countries of Eastern Europe.* East Germany initially moved all rents to levels covering operating costs and in exchange supported poor households via special rent allowances. This requires the ability to identify poor households, which in Egypt, could be done using the MOSS. Poland, Latvia and Russia similarly liberalized rents using rent allowances; in Poland, local government resistance later intercepted the rent adjustment process, however, Latvia and Russia allowed for market rent levels to be reached quickly. In the more strictly managed process in East Germany, in a second phase landlords were allowed to differentiate their rent charges within a predetermined range by the amount of investment in the unit. The investments were supported by a large public modernization loan program, requiring much administrative burden. In a final phase, many countries have adopted a reference rate (Germany) or indexation (Spain) system to govern rent adjustments and deter usurious rent levels.

*Political feasibility will likely be an obstacle to rent decontrol in Egypt.* Many rent control beneficiaries in Egypt (mainly Cairo) are said to be wealthy and politically influential. Europe has a comparable case in the Czech Republic, where prime location rentals in Prague are occupied by members of parliament and government for nominal rents. A case has been launched to the European Supreme Court to rule on the issue. Managing the transition in Egypt will require also either allowances or tax support for landlords in exchange for accepting low rents. In the case of Spain, due to a mix of fiscal concerns and program implementation issues, the process took almost 10 years. Many Egyptian landlords are finally reportedly impoverished and have little ability to keep operations in order, let alone to invest in their properties. This is a relevant constraint, as rent increases in the first phase will be accompanied by an obligation by the landlord to fund services taken over by tenants currently (i.e. elevator maintenance, repairs, sewerage, waste disposal). In a second phase, investment in the unit should occur. One option might be a public loan program to support landlords' ability to invest. Much will depend on whether the general investment climate for rental housing improves and new, better capitalized investors will come into the market (see below).

### Box 3: International Experience Provides Lessons for Rent Decontrol Reform

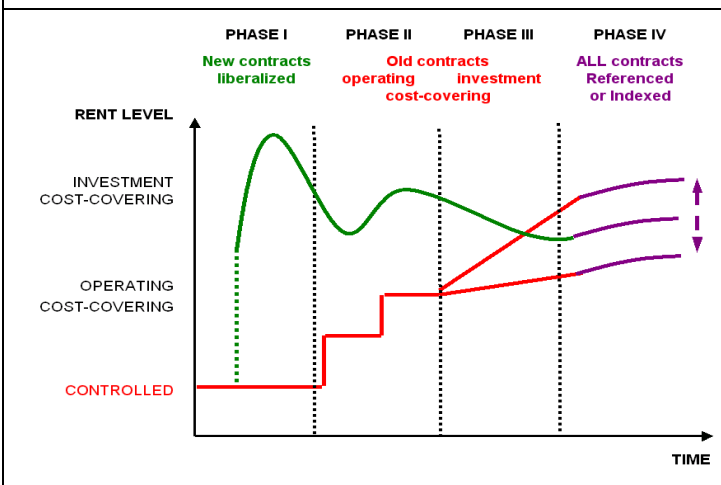
First, a gradual approach is recommended. Rent adjustments need to be phased in order to create gradual convergence toward market rents and limit the financial burden of tenants. However, initial shock adjustments are justified when controlled rent levels are extremely low compared to operating costs, in order to limit the losses from depreciation, which is the case in Egypt. Moreover, some sort of support for needy tenants should be designed. In Spain, the administrative complexities lead here to some reform delay.

Second, the agreement of tenants to a decontrol process cannot be obtained without a proportional service being provided by the landlord. This is clear in the case of rents that are not sufficient to cover current operating costs (Phase II in figure 12). However, beyond that level rent adjustments should be permitted in exchange for capital repairs and modernizations (Phase III in figure 12).

Third, final rent control regimes need to be defined for *all* rental contracts, eliminating inequitable situations between tenants.

Finally, while there is no systematic empirical analysis on the impact of liberalization on rent levels, there is ample anecdotal evidence of initial overshooting phases being followed by calmer periods, resulting in a decrease of initial tenant resistance (green line in Figure 12). The rule of thumb is that the larger the rent controlled stock relative to the total stock is, the more pronounced the initial overshooting and the more likely a subsequent relative decline in rents will be.

**Figure 9: Rent Decontrol Process – a Stylized Portrayal**



It is important that all rental contracts be treated alike. As the Spanish example shows, second generation rent legislation after an initial liberalization is often necessary in order to react to market failure, to significant increases in rent and contract term volatility, or to abuses. More importantly perhaps, in combination with de-grandfathering the regulatory system must unify the legal framework for all rental contracts and buy important political support for a de-grandfathering strategy by reducing popular anger against reforms.

Source: Finpolconsult



*In summary, it is recommended that Egypt initiate a second phase of rent reforms by de-grandfathering old law rents completely. When linked with the reforms proposed in Section 2.0, this would create a unified and rationalized regulatory framework for the rental market. It is recommended that the GOE phase out grandfathering of old law contracts by imposing operating cost recovery to be reached within a short period. In a second phase, additional rent increases should be allowed proportional to landlord capital repairs and modernizations. Tenants in need of temporary housing allowances or indirect tax support via landlords could be identified and supported during the adjustment period. Tenants may opt out of rent adjustments in return for eliminating their right to bequeath. If possible, contract term should be limited after inheritance to juvenile phase of heir, or to maximum term after death.*

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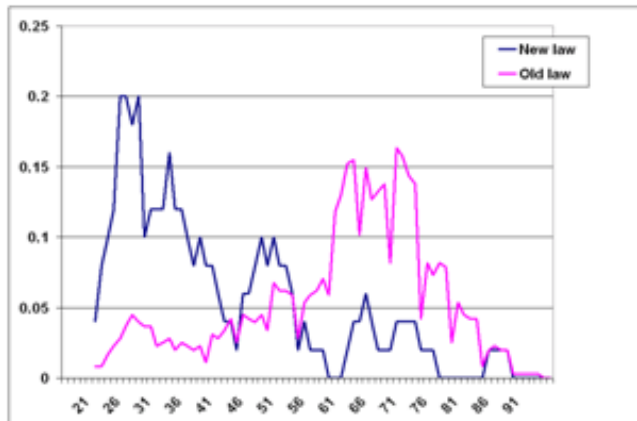
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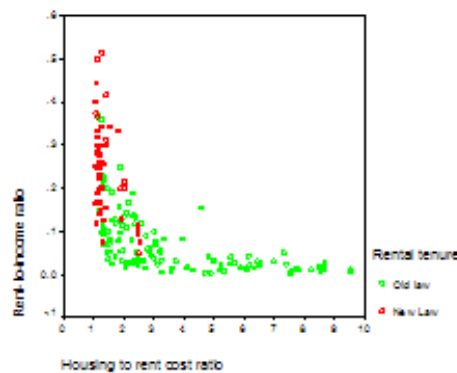
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## Age distribution – old and new law tenants (age of household head)



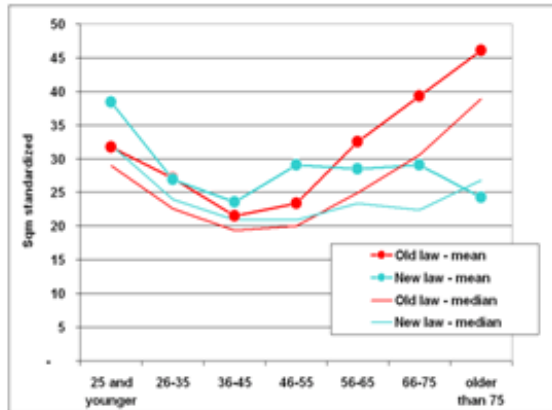
An accumulated 20% of old law tenants is under 45  
Vice versa, accumulated 30% of new law tenants are over 45.

## Impediment for adjustment : Many old law tenants pay high multiples of other housing costs



Includes repairs & maintenance, water & other utility costs, taxes.  
(Warning: low data numbers in survey).  
→ Reform concept should look at total housing costs, impose restrictions.

## Impediment # 2: Many old law tenants with excess housing consumption are old



→ Can incentives become strong enough for those tenants to rationalize their consumption? Will 'old' be politically confused with 'poor'?

## How many tenants would be eligible for rental assistance?



- Focus on first and second standardized income quintiles of old tenants.
  - High share of larger families → covered by other allowances?
- Eligibility ratio/subsidies per household depend on approach:
  - Max housing-cost-to-income ratio (steeply increasing subsidies with lower income).
  - Combination of income and housing cost ceilings (with less steeply increasing subsidies)
- Further calculations necessary depending on rent adjustment scenarios. Focussed interviews of, revisits of low-income tenants.

### Old law tenants – possible allowance eligibility scenario

Possible eligibility for allowances			
Quintile	Quintile share	Allowance ratio	Allowance Total
Q I	18%	100%	18%
Q II	19%	50%	10%
Q III	21%	10%	2%
			<b>30%</b>

Source: Finpolconsult presentation.