

**Rental Choice and Housing Policy Realignment in Transition:
Post-privatization Challenges in the ECA Region**

- Introductory Study -

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December 2005

Abstract

Massive privatizations of housing in ECA transition countries have significantly reduced rental tenure choice threatening to impede residential mobility. Policy makers are intensifying their search for adequate policy responses aimed at broadening tenure choice for more household categories through effective rental housing alternatives in the social and private sectors. While the social alternative requires substantial and well balanced subsidies, the private alternative will not grow unless rent, management, and tax reforms are boldly implemented and housing privatization truly completed.

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Acknowledgements

The authors thank Sudeshna Gosh, World Bank, for her significant contribution to the study. The following people provided assistance and comments:

- *Armenia*: Steve Anlian (Urban Institute), Gevorg Sargsyan (World Bank)
- *Lithuania*: Vytautas Jonaitis, Elvyra Radaviciene, Vilma Vaiciuniene (Ministry of Environment), Eduardas Kazakevicius (Central Project Management Agency), Keistutis Nenius (City of Vilnius), Gedeminas Reciunas, Tomas Milasauskas (Lideika, Petrauskas, Valiunas and Partners)
- *Poland*: Andrzej Bratkowski (Ministry of Infrastructure), Marek Zawislak (Ministry of Infrastructure), Edward Kozlowski (REAS Konsulting), Elzbieta Szczawinska (City of Krakow), Henryk Rand (Property Managers Association)
- *Romania*: Ion Bejan (Ministry of Transport, Construction and Tourism, Bucharest), Christina Stoica (Legal expert, Bucharest), Illeana Budisteanu (Consultant)
- *Russia*: Peter Ellis (World Bank), Alexander Puzanov, Tatiana Lykova (Institute of Urban Economics), Louis Skyner (Institute of Law and Public Policy), Tim Lassen (German Mortgage Banks Association)
- *Serbia*: Goran Milicevic (University of Belgrade), Mina Petrovic (University of Belgrade)

Acronyms and Abbreviations

ECA	Europe and Central Asia
EU	European Union
GDP	Gross Domestic Product
HOA	Homeowners Association
HBS	Household Budget Surveys
HLM	Habitation à Loyer Modéré (French social housing system)
LSMS	Living Standards Measurement Surveys
M-F	Multi-family (building)
PPP	Public-Private Partnership
TBS	Towarzystwo Budownictwa Społecznego (Polish social housing system)
USAID	United States Agency for International Development
VAT	Value Added Tax

EXECUTIVE SUMMARY

Research Strategy

This introductory study tests empirically the key hypothesis that households in the Europe and Central Asia (ECA) region lack access to efficient rental housing they should be expecting. This hits especially the young and mobile, as well as the poor and the elderly. Domestic policy makers, who are increasingly talking about the need of rental housing choice, should consider realigning their housing policies and start enabling and promoting a competitive and efficient formal rental market.

To test the key hypothesis, given the considerable resource constraints for this introductory study, a six-country sample was used to reflect different housing sectors and housing reform environments—Armenia, Poland, Lithuania, Romania, the Russian Federation, and Serbia (without Montenegro). The study used disaggregated household datasets, other available statistical and survey evidence, and interviews to arrive at an empirical picture of the rental sector in those countries and test the null hypothesis. The study also considered investor types and legal, regulatory and taxation issues that prevent swifter rental sector development.

Main Empirical Findings

Rental supply in housing sectors in the ECA region is smaller than expected in mature market economies with similar patterns of demographics, incomes, mobility needs, and building inventory.

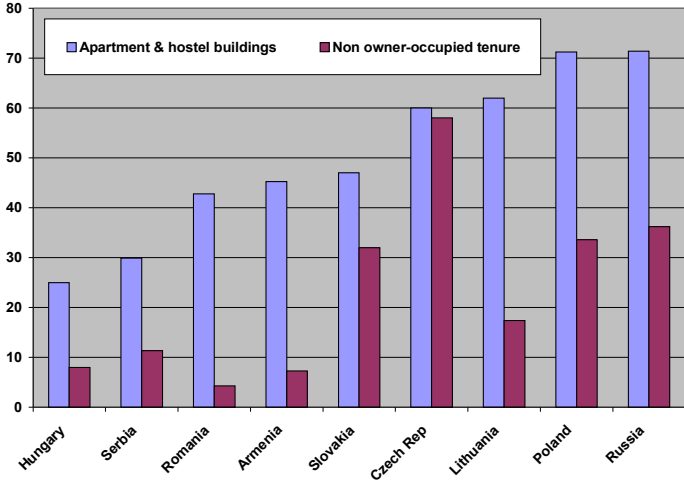
This is especially so in Armenia, Romania, and Serbia where the formal rental sector is a barely traceable residual. In Russia, the rental sector is significant, but only because it consists primarily of social (municipal) rental housing slated for eventual privatization. In Lithuania, social (municipal) rental housing has been decimated, but there is a lively, mostly informal, private rental market in individual apartments. In Poland, the significant rental sector includes formally restituted prewar rental apartment buildings, and cooperative rental apartment stock, as well as the “regular” social (municipal) rental apartment stock.

There is also evidence of a large shadow rental sector that survived the privatization wave. With the notable exception of Poland, in the broadly defined apartment sector, ownership titles to common property in multifamily (M-F) buildings and surrounding grounds are lacking. Such facilities continue to be serviced and maintained mostly by public sector companies typically owned by municipalities. It points to an important side effect of the mass privatization: significant unintended inefficiencies. The privatizations mostly failed to produce either genuine homeowners or professional rental investors willing and able to undertake maintenance and capital repairs on common property in the multifamily buildings dominating ECA urban areas.

The correlation between building type and tenure form is a crude measure - but the closest available - of housing choice in mature market economies. The preponderance of M-F buildings in the housing stock of ECA countries suggests a much higher incidence of rental tenure than is the case, given that rental form is the easiest for managing such buildings. The incidence should be between 20 percent in Serbia and 40–50 percent in Poland and Russia, but none of the studied countries comes anywhere close to that range (Figure 1).

Figure 1

Building Structure and Rental Tenure in Some Transition Economies



Source: World Bank LSMS study, Lithuanian Household Survey, national statistical offices. *Note:* For the Czech Republic and Slovakia all units in housing cooperatives were counted as non-owner-occupied because of the lack of detailed data on renting

Demand for private rental is rather strong among its typical household groups - the young and mobile - consistent with patterns found in mature market economies. Higher incomes of many younger households, typically the winners in economic transition, drive up private sector formal and informal rents in the most attractive cities. However, the lack of a consistent investment framework for formal private rental housing accommodates elastic expansion of supply, discouraging additional migration from smaller cities and rural areas. Consequently, the restricted rental tenure choice is likely to compromise macroeconomic performance in the studied countries, and by inference in the other ECA transition countries.

Residual social rental housing, decimated by the mass privatization, cannot accommodate the newly created post-privatization households who are poor, let alone the young and mobile, to any meaningful degree. Occupancy of the social housing stock in these countries is dominated by the previously allocated tenants and thus lacks socioeconomic targeting for the current dynamic situation. In the few cases where the sector has not been marginalized, highly subsidized rents effectively lock sitting tenants into their dwellings, preventing any significant adjustment, restructuring and reallocation within this stock. Inadequate public resources and programs maintain the weak supply responsiveness in the existing social housing.

With regard to the price impact of these apparent imbalances between demand and supply, the studied countries fall in three groups:

1. The most advanced transition (and EU accession) countries of Lithuania and Poland experience strong demand pressure for renting and keep somewhat responsive supply, which mitigates the upward pressure on private rents.
2. The advanced transition countries of Romania and Russia experience high demand pressure for rental apartments, coinciding with a pronounced scarcity of rental housing supply and resultant very high private informal rents.
3. The least advanced post-conflict countries of Armenia and Serbia experience relatively subdued demand for housing in general, including rental housing.

Rents in all jurisdictions continue to be set at regulated, non-market-clearing levels, constraining both public and private rental stock. These first-generation “hard” rent controls contravene the main thrust of pivotal market and property rights reforms and are the result of holding the rental sector captive by populist rhetoric.

The empirical findings support the key hypothesis of broadly insufficient rental housing choice of households, although the general economic situations and varying policy frameworks differentiates specific results for countries, regions and localities.

Main Findings of the Policy Review

Progress in legal and regulatory reform of rental housing has been slow. Rent reforms face strong political resistance from privatized tenant-owners and from social tenants, both groups benefiting from the low maintenance costs and controlled rents maintained by public providers and regulators.

In most studied countries the private rental sector is informal and undocumented because of the ease of tax evasion and the imposition of hard rent controls. Institutional or other professional investors in rental housing are found only in isolated cases. Poland is the most advanced in enabling private rental investment through tax and fiscal support; for example, individual investors act as co-financers of new non-profit rental housing or as owners of restituted prewar rental buildings¹. However, legal and rent control issues remain largely unresolved despite considerable recent progress. Lithuania has also taken steps toward formalization by improving

¹ Non-profit rental housing system TBS requires that tenants participate in construction cost, see p. 50.

the tax environment, and Russia has started to improve rental laws in formal social housing. Still, none of the studied countries has an effective dispute resolution and eviction system. Tax regimes also discourage private investing in rental housing, except to a degree in Poland.

All studied countries except Serbia and Armenia recently began supporting social rental housing construction, in response to the growing frustration over sagging construction activity and growing numbers of “social” households. However, the programs are generally small and heavily subsidized, and thus unable to resolve the housing problems of the poor. Except in isolated urban areas (Moscow, Bucharest), there is no general strategy of using moderately priced existing units for social rental and thus enhancing program outreach. The public rental sector also suffers from low rent setting and inadequate regulation. Only Poland has expanded the concept of social housing, by supporting public-private non-profit rental housing, and retained the form of cooperative (and thus also non-profit) tenant apartments.

Recommendations to the Studied Countries

Governments should formulate more explicit rental housing policies and implement the requisite programs as part of the post-privatization realignment of their housing policies. Rental choice policies should be seen as vital life-cycle and poverty-focused complements to homeownership policies, not as mere residual and temporary measures.

Governments should consider anchoring their rental housing policies on a competitive, private, formalized rental sector, supplemented only by well targeted social rental housing programs. Greater private resources should be mobilized into the rental sector through programs aimed at developing the private market, public-private partnerships (PPPs), and non-profit sectors. Reliance on the private rental sector requires abolishing hard rent controls as well as developing transparent and balanced landlord-tenant regulations, including dispute resolution and eviction procedures; securing sufficient competition to prevent usurious rent seeking; further developing fledgling housing allowance systems; and enacting tax regulations that assure tenure-neutral treatment of housing sector investors.

Some governments are interested in fostering a non-profit rental housing sector to address housing affordability problems of middle-income and lower-middle income households, those who are “too poor” to afford (even subsidized) homeownership and who are “too rich” to qualify for social housing or housing allowances. Only Poland has a state-sponsored program in this area, but its experience should be examined in depth to bring out lessons and possible modifications for other countries.

Whatever the ultimate policy design, public housing budgets in the studied countries are far too small to comprehensively resolve the problems of the rental sector through subsidies. There are two directions for engaging public efforts and expenditures: create incentives for larger private sector involvement in market-driven or PPP non-profit rental investments and operations; and create a small but sustainable—and hence manageable—social housing sector.

the efficiency and goal attainment of policies. Too few resources are devoted to public communication, data monitoring, and managerial, analytical, and comparative work. This raises the risk of costly misallocations of scarce public resources and calls for building explicit institutionalized mechanisms for both central and local governments.

Need for Further Research

The findings of this introductory study suggest a need for more comprehensive ECA region-wide policy and empirical research focused on rental tenure choice and sector, so that a full comparative understanding can be compiled including actual practice cases of various policies, programs, and instruments for others to learn about, discuss, and possibly adapt to their own countries. Regardless of the number of countries covered, there is a need for follow-up research on both empirical and policy themes.

In empirical research there is a need for institutionalized monitoring of the rental sector, through improved census work and housing sector reporting, and supplementary specialized surveys on rental housing at various levels of government.² For tenure policy research two themes are relevant: (i) detailed analysis of country rental housing policy frameworks; and (ii) cross-country comparative policy studies to deepen understanding of actual practice. There is also a need for better understanding of the impact and constraints of specific policy measures and programs. Analogies from other sectors could broaden the feasible policy menu. This should include alternative taxation models and regulatory incentives or impediments.

Linkages to broader economic issues should include the role in poverty alleviation and labor mobility strategies of the public sector acting as a rental housing investor providing “market additionality”, while not replacing the formal private rental market. Partly due to political and ideological inclination toward homeownership, research into new public investment strategies in the form of rental PPPs, or non-profit rental forms has almost subsided over the recent decades, so there is a need to resume research in these directions.

The issue of inter- and intra-governmental housing policy institutional architecture should be studied to improve understanding of where housing policy is formulated and implemented. Anecdotal evidence suggests a wide variety of institutional anchors for housing policy both within central governments and between central, regional, and local government levels. The institutional fragmentation of housing policy formulation and implementation has discouraged development of comprehensive and cohesive housing strategy in many countries. Realignment of institutional infrastructure towards stronger coordination should be investigated.

² See Annex 2 for an outline of survey contents assuring consistency.

1. INTRODUCTION

Background and Setting

After the Soviet economic system breakdown during 1989–91, rapid privatization of housing to sitting tenants became a pillar of fledgling housing reforms, intended to establish the vested interests of the majority of population against possible reversals of the overall processes of economic reform and democracy building. Decentralization of most social policy competencies to regional and local governments supported the thrust to build an ownership society immune to communist ideology.

However, the broad expectations that housing sector “micro” privatization would lead to higher investment and asset management efficiency was not realized in respect to multi-family (M-F) buildings that continue to dominate the housing stock. *First*, after governments withdrew from direct provision of housing through new construction, housing production figures plummeted throughout the ECA Region. The major turnaround came only recently, 10–12 years after the inception of the reforms, and the Region still lags behind others with comparable housing needs and income levels. *Second*, a thorough modernization of the M-F building stock—already a major issue in the early 1990s - became ineffective under the new privatized ownership structures, which left common property components of this stock without incentives for responsible decision makers for building management and hence, investors. *Third*, formally turning tenants into owners did not change the inherited social and cultural mentality that housing is a merit good. Perception was grounded continued that the jointly owned common areas of M-F buildings and surrounding grounds were in fact “extensions of the street”, and thus should be maintained and repaired by municipalities, so that apartment owners and tenants should continue making low nominal payments on top of their own utility bills.

The high nominal homeownership rates achieved through mass privatization of the above type had profound implications for housing demand. The marginalized rental sector severely constrained the development of competitive, market-based tenure choice options that could be exercised by economically diverse households according to their income profiles, family and job situations, and personal preferences. Small-scale, often informal, yet spontaneous private rental activities began soon after and some new public rental housing was built on a very limited scale. But the rental sector as a whole - a strategically important sub-sector catering to important household groups - has become an overlooked residual of the privatization driven reforms.³

Soon after the “give-away” privatization of apartments was mostly completed an increasing number of experts and policy makers in transition economies began to realized that reforms based on privatization only were grossly unfinished and incomplete, lagging other sectors and inspiring the saying “neither Marx nor market” (World Bank 2001). Presently, many governments in the Region are attempting to pull diverse housing-related reforms into more

³ The UN Habitat (2003) rental housing report states bluntly that “Few governments have taken rental housing seriously over the past thirty years” and discusses the reasons for this neglect. Furthermore it states: “Unfortunately, little has actually happened, and recognition of the important role played by the rental sector still constitutes perhaps the greatest hole in most national housing policies.”

comprehensive and cohesive strategies focused on availability of housing choice to segmented household groups rather than the traditional Soviet-period focus on the quantity and quality of the housing stock. This paradigm shift has led policy makers to discover the “rental gap” and made them request policy dialogue with the Bank on these issues.⁴

Purpose of the Study

In the post-privatization “soul searching” in the housing policy arena, growing numbers of policy makers in transition countries are searching for measures to secure broader availability of rental tenure choice and greater dynamics of modernization and new construction through a more significant and efficient rental sector. To this end they seek a housing policy dialogue broader than homeownership and look for access to analytical assistance and a knowledge base in rental housing area. This introductory study is seen as an attempt to meet this growing need by compiling and developing further the insufficient knowledge base in this area.

The over-arching purpose of the study is then to help develop the housing reforms knowledge base -both conceptual and empirical - in rental tenure choice, so that to respond to the needs for policy dialogue with transition countries. Such a dialogue calls now for engagement in issues well beyond homeownership and privatization, and towards formulation of comprehensive housing strategies addressing the key political issue of housing choice for all household types in terms of dwelling type, standard, location, and tenure form. The focus on development of rental housing sectors, the subject of this study, should contribute to development of such comprehensive housing strategies.

Objective and Key Hypothesis

The objective of the study is to better understand urban housing rental tenure choice for diverse household categories and segments in the transition economies. The main question is this: Is urban housing rental tenure choice sufficient, and have governments adequately considered and handled this issue in their policy making?

The key hypothesis is then formulated as follows: ECA households lack required rental housing choice in an efficient rental sector; consequently governments need to realign their weak and ineffective rental housing policies.

This hypothesis reflects the belief that the ECA countries, through their early enthusiasm for homeownership and privatization, have not paid sufficient attention to rental housing choice of households that need to adjust their housing “consumption.” And some may have waited too long with addressing this issue. Their policies on rental housing, if articulated at all, have been weak and ineffective, focused on subsidizing the replenishment of social housing, rather than enabling and encouraging the growth of a robust formalized private rental sector. As a result of the mass privatization, the failed rent reforms, and the lack of rental housing policy, many households that did not benefit from privatization now face severely constrained tenure choice.

⁴ Poland, Lithuania, Latvia, and Romania have been in informal dialogue with the Bank over rental tenure choice issues.

Methodology

Due to resource limitations, this introductory study is necessarily a rapid exploratory assessment. Six countries form a sample representative of different stages of housing sector and policy development (Armenia, Lithuania, Poland, Romania, Russia, and Serbia).⁵ For this group the study is the first in-depth tenure structure analysis with disaggregate household data using the Living Standards Measurement Surveys (LSMS) and annual Household Budget Surveys (HBS). These data are enhanced by other evidence from national statistics, analysts' reports and findings,⁶ and interviews with experts and market participants in all six countries. The review of policies and best practice relies on interviews and selective analysis of legislative and regulatory texts. More in-depth analysis is both desirable and possible, but the form of analysis used in the study provides sufficient insight to support, or reject, the key hypothesis.

Organization of the Report

Chapter 2 discusses conceptual considerations about what determines rental sector size in a market economy and the basic drivers of rental demand and supply found in the literature. It also briefly addresses the implications of the existence of rental sectors for economic efficiency, and rationales for policy interventions designed to support or create efficiency.⁷

Chapter 3 provides a basis for supporting or rejecting the key hypothesis. It identifies supply and demand structures that correspond with the conceptual framework and main issues identified in Chapter 2.

Chapter 4 deals with actual tenure choice policies in the studied countries in three ways:

- *First*, by analyzing existing investor types and the extent to which they pursue formal or informal market practices, and how their basic business models are structured.
- *Second*, by identifying gaps in the legal and regulatory frameworks governing rental contracts and tenant-landlord relations, then analyzing the tax environment.
- *Third*, by discussing the broader housing policy context of tenure choice policies in the studied countries, giving specific attention to the privatization, “communalization,” and restitution processes, as well as to the current strategies of retaining and redeveloping a social housing sector.

Chapter 5 concludes whether the key hypothesis is supported by the gathered and analyzed evidence. Further research needs to strengthen the findings and enhance the knowledge base are

⁵ Countries represent various groups: Armenia, small post-Soviet countries; Lithuania, small EU accession countries; Poland, large EU accession countries; Romania, medium EU pre-accession countries; Russia, its own category; Serbia, postconflict southeastern Europe.

⁶ The LSMS and HBS are administered by the statistical agencies within each country with technical assistance from donor organizations. In Russia a one-time survey, the NOBUS, was used. This survey, administered by the statistical authorities, was intended to improve on the questionnaire design of the annual HBS.

⁷ For more detailed discussions of available theories and evidence see Annex 1

outlined. Recommendations to policy makers interested in broadening housing choice by expanding rental tenure availability are offered.

The annexes contain: (1) a review of relevant literature; and (2) a possible outline for rental housing surveys to support informed policy debate and intervention design.

2. CONCEPTUAL CONSIDERATIONS

Determinants of Tenure Patterns

The literature review (Annex 1) reveals that no convincing equilibrium theory of housing supply and demand yields reliable predictions about optimum homeownership levels, and conversely optimum rental sector size. Ideological and partially analytic approaches dominate the literature; most are embedded in simple microeconomic models that by definition lack the structure to sufficiently explain the wide data variability observed. Rental sector size in Europe alone varies across countries between 3 percent and 55 percent of the number of housing units.

The most widely used class of models focuses on the demand side. The literature on tenure choice focuses on the household's utility maximization arising from its housing investment or consumption decision for or against homeownership or rental. In the typical model, such a decision is usually influenced by household income, age or stage in the life cycle, and a range of specific household characteristics such as family status (single or married), number of children, and professional status. Given the shortcomings of this class of models, extended versions consider that the household can finance a higher housing consumption level by borrowing on the financial markets. Also, fiscal support schemes that enhance demand for rental or for homeownership (housing allowances, low-interest loans, capital grants for homeowners) are considered (see Annex 1).

Who Tends to Rent?

The tenure choice literature indicates several rather reliable predictions, which are grounded in the empirical literature. It suggests that the likelihood of a household opting for rental tenure tends to:

- Decrease with household income levels and age; however, it may increase during retirement because of life-cycle consumption considerations⁸
- Increase with income uncertainty, individual search activity for jobs, divorce incidence, and need for mobility;
- Decrease with household size, importantly influenced by household type⁹
- Decrease - at least in younger age groups - with improved access to mortgage loans with low down-payment requirements
- Decrease with an increase in the ratio of mortgage market subsidies relative to comparable rental demand subsidies

⁸ Depending also on such factors as inheritance taxes and the strength of individual motivation to bequeath property.

⁹ Single, couple with no kids, families, etc.

- Decrease with an increase in the relative risk-adjusted return of housing investments to other investments
- Decrease with an increase in the propensity of a household to save.¹⁰

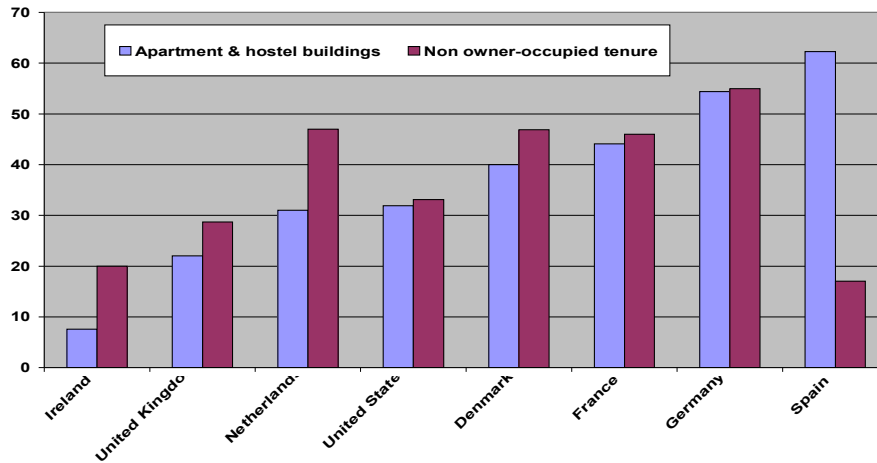
In the empirical literature, cultural factors are sometimes identified as significant determinants of homeownership preferences that are hard to capture in economic models. Examples are the depth of religious and family values and broader social preferences for or against community ownership.

Unfortunately, the tenure choice theories invariably treat rental housing supply conditions as given, which seems grossly inadequate even after cursory inspection of the data. Consider that the share of M-F apartment buildings in mature market economies—with similar income distributions, household characteristics and access to finance—closely correlates with the size of the rental sector (Figure 2). This is hard to reconcile with standard predictions made by the tenure choice theories, for which supply structure is irrelevant. In contrast to the relatively well developed demand-side theories, the supply conditions that influence tenure choice in equilibrium are surprisingly under-researched. For example, after adjusting for demand determinants, larger cities typically have significantly larger rental sector shares than smaller cities; why? And neighborhoods within cities are known to compete,¹¹ resulting in some being predominantly rentals and others predominantly owner-occupied. However, a new generation of spatial economic theories should be likely to contribute to the necessary theoretical development (Tirole 1990; Fujita, Krugman, and Venables 1999).

¹⁰ Which in turn correlates with income and other characteristics as well as such macroeconomic factors as the type of retirement system.

¹¹ Such competition must be considered imperfect, given that land is not tradable—which could be addressed by applying monopolistic competition theory.

Figure 2
Building Structure and Rental Tenure in Some Market Economies



Source: Authors' calculations using National Agency for Enterprise and Housing (Denmark): Housing Statistics in the European Union (2003), UN-ECE (2004a), Joint Centre of Housing Studies (2004).

A second strand of supply-side theory, subsumed in the Theory of the Firm, may help explore the effect of complex ownership structures. Complexity in decision making (for example, about modernizing common areas including building envelope and surrounding grounds, and coordinating costs among apartment owners) prevents higher penetration of M-F housing stock with condominiums or cooperatives. Empirically, those do not exceed 5–10 percent of the M-F housing stock, even in mature markets. However, true privatization of M-F apartments requires functional collective decision making and coordination in respect of jointly owned common property.

The Theory of the Firm also deals with determinants of optimum firm size in different industries: under which conditions, for instance, do small private landlords emerge as suppliers of the rental “product”? Under which conditions do large institutional investors supply the rental product? Strikingly, even in countries with developed mortgage markets supported by few large banking firms, the typical residential rental landlord is very small. This holds even though both types of landlord firms in essence provide the same financial intermediation service, namely financing long-term assets. Does the prevalence of small rental landlords reflect artificial market barriers for larger and more efficient firms, or are they efficient as a reflection of the problems of information flow and control span that prohibit larger firms from entering? If artificial barriers exist, what exactly does it take to encourage the emergence of large investors or “servicers” in the rental market that could drive down rents or enhance service quality?

Social choice theories may also help in understanding the supply side of renting. Why do some mature market countries maintain extensive social rental housing programs (as in The Netherlands), while the programs of their immediate and culturally close neighbors are much

more modest (as in Belgium)? This situation may arise from preferences of the median voter, who in The Netherlands is a renter and in Belgium is an owner. Social choice could help explain the preponderance of social renting in transition countries before 1989. The dismal housing situation of the working class was a major issue in the revolutions of the early twentieth century that produced Soviet socialism. But it may also explain the inertia in dealing with many of the current housing policy problems in the Region. For example, the median voter in ECA transition countries is a former renter turned owner (tenant-owner) in a M-F building privatized almost for free (give-away privatization). The median voter in the United Kingdom or United States is an owner who bought a housing asset on the market through considerable effort that continues over the term of mortgage loan repayment. And homeownership in some countries focuses mostly on homes rather than apartments, which does not have to deal with a difficult issue of jointly-owned common-property management, maintenance and repairs. In other countries, where apartment ownership is more significant, this issue gains more importance and affects the way M-F buildings are owned and managed. Not surprisingly, housing policies and instruments differ in societies with such fundamentally different experiences and political economies. These widely differing circumstances have contributed to communication problems in comparative housing policy research and debate.

The application of the “emerging” theories to housing and particularly to tenure issues belongs to a work program of the future, and is beyond the scope of this study. However, there are two relevant bodies of literature dealing with rental housing supply within a rudimentary equilibrium theory approach: (i) on the theory of rent control; and (ii) on the theory of residential filtering process.

Rent control and its distorting effects, including politics, populism and implications for housing market equilibria, have been extensively researched. The literature survey (Annex 1) gives an overview of these issues. The economists’ verdict against first-generation “hard” rent controls and ceilings is universal; however, more indirect, softer forms of second-generation rent controls that cap only usurious (short-term monopolistic) practices have been found to exercise a demand-stabilizing effect. Again, the theories are not sufficiently rich in structure to explain partly diverse empirical outcomes.

The theory of residential filtering (trickle-down) seems more useful, so far. Consider several submarkets of the housing sector that compete for consumers. Consumers gain in housing consumption capacity over their life cycle and face financial and transaction cost hurdles when trying to realize their perpetual desire to upgrade their housing status.¹² Filtering assumes not only that households change submarkets over their life cycles, but also that supply changes too, as older units filter down in the rent hierarchy, until they are modernized or exit the market through dilapidation and demolition. No rigorous specification of this model with modern economic theory tools is known to us; however, its rich structure has the potential to integrate both complex supply and tenure choice elements in a consistent equilibrium theory. As discussed later (Annex 1) in more detail, numerous conclusions can be drawn for tenure policies and need to be researched further. The most important one is that price controls or subsidies in a specific

¹² For example, from living with parents to subletting, from subletting to renting, from renting to owning a small house, from owning a small house to owning a large house.

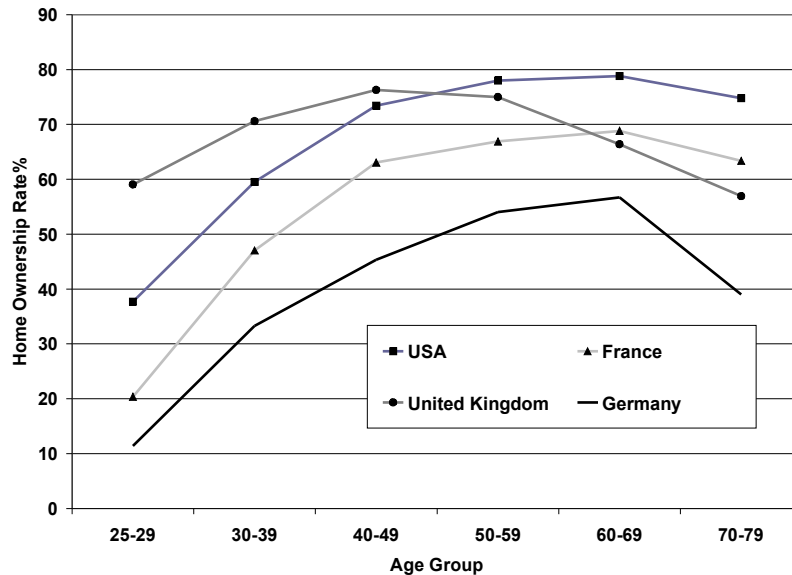
sub-market may impede the entire filtering chain, leading to a decline in overall housing investment.

Summarizing the small body of applicable supply-side literature, one may predict that households tending to be renters will:

- Decrease as land prices decline, allowing for lower urban densities and less complex building structures
- Increase with economic agglomeration effects
- Increase with inter-urban and inter-regional changes in economic dynamics and city hierarchy, which warrant higher labor mobility
- Increase with complexity of the housing production and management structures, which raise the costs of individual homeownership
- Increase with efficiency of the servicing of rental contracts, which in turn depends on local conditions for optimum firm size for landlords
- Increase with the level of legal and regulatory property transaction costs, which raise the costs of homeownership
- Decrease in societies where the median voter is a homeowner, which is likely to introduce a bias in housing policy programs in favor of owning
- Decrease with the level of “hard” rent controls, such as fixed rent ceilings, typical for first-generation rent-setting policies
- Increase with the amount of units filtering down to uses affordable by household types predicted to be renters under demand-side utility maximization.

Can all these partial hypotheses concerning demand and supply aspects of tenure choice be condensed to arrive at a single measure that indicates the equilibrium likelihood of renting, and - aggregating over households - the equilibrium share of the rental sector? Obviously, such a theory does not yet exist, let alone empirical testing methodologies. The issue has been dominated by ideologically inspired paradigms of homeownership’s positive externalities on the one hand, and “nation of homeowners” political economy arguments on the other hand.

Figure 3
Home-ownership by Age in Some Market Countries



Source: Chiuri and Jappelli (2000).

In this respect two robust empirical results should be noted. *First*, there is an apparent correlation between building and tenure structures (Figure 2).¹³ This suggests that there could be a supply-induced inertia when attempting to increase the share of owner-occupied units in jurisdictions with large M-F stock that was designed and produced for rental. This issue is a central point in the discussion below regarding transition countries. *Second*, as Chiuri and Jappelli (2000) have shown, homeownership rates at retirement age are far less variable across (European) countries than rates at the age of 20 or 30.¹⁴ This indicates the paramount importance of low-cost, low-risk access to housing services during the third stage of the life cycle, as well as the pivotal function of real estate ownership in diversifying retirement asset portfolios. And vice versa, there is less of a need for tenure security and portfolio diversification in the earlier stages of the life cycle (Figure 3).

¹³ The two outliers, The Netherlands and Spain, can be partly explained by policy peculiarities. The Netherlands has traditionally emphasized social rental, which includes detached housing. The Spanish rental sector, on the other extreme, has been depressed by decades of rent control. Eastaway and Varo (2002) discuss the Spanish case.

¹⁴ In their survey of 13 countries, ownership rates at ages 50–59 vary 53 - 82% while at ages 30–39 they vary 33 - 70% and at ages 25–29 they vary 11 - 59%.

Tenure Pattern and Economic Efficiency

One may also consider a reverse causality: Will the existence of a rental sector in equilibrium facilitate economic efficiency? Two candidate factors are of particular interest for higher efficiency: (i) labor market; and (ii) land / housing market.

The popular notion that homeowners are less likely to move than tenants is well grounded in the literature pointing out the virtues of this to community stability, social attitudes etc. The degree to which higher homeownership contributes to labor market imbalances is somewhat less studied and clear. It should decrease or increase with the amount of compensating subsidies; for example, through regional policies (investment support, infrastructure projects). However, a stand-alone impact of high ownership rates, particularly by young households, is quite plausible.

And vice versa, economies with small rental sectors are expected to face increased migration costs and thereby a reduced elasticity of the labor supply relative to spatial wage differences. The reason is that migrants, at least initially, face job tenure and income insecurities and thus seek to reduce housing search and transaction costs, which are lower in the rental sector. Analysis for the United States shows that because of these factors two-thirds of migrating homeowners become tenants first (Joint Center for Housing Studies 2003).

A recent report on rental housing by the United Nations Human Settlements Programme (UN-Habitat) (2003) makes the point that there may be an inverse relationship between unemployment and homeownership.¹⁵ This supports our contention that high levels of homeownership reduce residential and hence labor mobility, which is better served by rental housing - especially in transition countries. The role of the housing market in labor mobility is to be studied by the Bank in upcoming economic and sector work.¹⁶ With similar arguments, the absence of a rental sector of a minimum size may impair housing sector and urban development. This is not well researched, but it seems plausible that cities in jurisdictions with constraints imposed on rental supply - such as rent controls - by the complexities of condominium creation and management, are likely to give preference to homeownership in detached housing and produce lower urban densities and larger sprawl. Cities with insufficient densities could become inefficient production locations. However, the reverse problem may also arise: abundant rental supply, especially if caused by policy interventions discouraging homeownership or reducing land supply for detached housing, may lead to excess densities in suburban locations and distorted land-use patterns.¹⁷

Rationale for Tenure Choice Policy

It is beyond the scope of this introductory study to make further conceptual elaborations of supply and demand in the rental sector in transition countries. In the sector policy debate, the formal-informal dichotomies and differentiations of landlord types play an important role.

¹⁵ The cited study estimated that a 10 percentage point increase in homeownership could be equated with an extra 2.2 percentage points of unemployment.

¹⁶ Ongoing EU8 cross-country study on the geographical mobility of labor.

¹⁷ Bertaud and Renaud (1993) discuss the land use patterns of socialist cities, which led to severe pricing distortions and hence misallocation of investments because of their planning constraints.

Essential questions arise, such as whether informal renting is good / efficient or bad / inefficient, what the optimum scale of social rental housing supply should be, and whether hybrid ownership forms (cooperatives, public-private partnerships) should be preferred to leverage public resources. Given the history of the Soviet-type public rental sector in these countries, further analysis is focused on describing the current role of public and private formal landlords.

Looking beyond this study, the fundamental conceptual difficulty is to develop a normative perspective of public goods that should be delivered through housing policy interventions, and then discuss a set of policy instruments to stimulate either the supply or demand sides that are sufficiently efficient to support the housing consumption or tenure security of specific target groups. The public good definition in this context is difficult: should the policy support the housing consumption of low-income households, or raise the global housing consumption standard through regulatory means, or both? Before the age of public housing interventions, in the XIXth Century, the answer was the filtering down of units from higher to lower quality levels, thus matching household means with housing consumption levels. The very *raison d'être* of the emerging instrument of housing policy in the early XXth Century was to change this market outcome by enshrining minimum housing consumption standards in building codes.

Setting high minimum standards for the stock is a double-edged sword, however, because it forces modernizations that break the filtering chain at a certain quality level, and leaves households that fall between the cracks if insufficient subsidies are available to support purchase or renting of modern units. Homelessness or over-crowding may result. Typically in ECA, the overlooked groups tend to be the young and mobile who support the economic dynamism of the Region's transforming economies. Moreover, enforcing such minimum standards to favor urban households—that is, those who live in areas yielding high labor productivity (with subsidies generated through tax payments of all households) – leads to mistargeting. A body of literature on urban bias addresses such policy distortions. Securing the minimum housing quality and size constitutes a strong public intervention that deals with multiple goals and accepts the reality of imposing negative externalities. It not only requires a comprehensive system for target group screening, monitoring, and delivery - essentially the infrastructure of the welfare state - but also generates the need to counterbalance its distortionary effects in the labor and land markets through additional, corrective policies.

In the 1980s, growing frustration over the inefficiencies of the European and North American welfare states inspired intense debates on the proper mix of policy instruments. Particularly frustrating was the fact that the dominating public housing policy instrument could not cater to many needy groups or even fulfill basic safety net functions in economies characterized by high dynamism and labor mobility. After decades of supply-side policy measures that pushed public housing ownership to record levels, many countries switched their policy focus to the demand side: rental allowances became popular and governments embarked on housing privatization programs and supported low-income housing supply from other than public sources - for example, through buying occupancy rights in the private rental sector and promoting cooperatives. This debate ultimately broadened the definition of public intervention from the narrowly defined concept of public housing provision to the demand-oriented concept of social housing.

3. EVIDENCE OF TENURE CHOICE

Data and Methodology

The data used in the study and presented in Table 1 are collected from the LSMS and HBS, nationally representative surveys developed to evaluate and track national living standards with the assistance of the World Bank and other donors.¹⁸ The HBS includes more questions on household budgets than the LSMS; however, both surveys include information for creating a socioeconomic profile of households. Both have an advantage for housing sector analysis in that they focus on households, not physical housing stock units, so that questions about residuals arising from census data are of minor relevance.¹⁹ The study team has analyzed the survey datasets available for five of the six studied countries for the most recent available year. For Lithuania, a specific household survey was performed in 2002 in cooperation with the World Bank with detailed housing sector questions, which qualifies it as a comparator.²⁰

Table 1
Household Survey Data Descriptors

Country	Year	Survey	Households	Households in urban apartments	Income proxy used
Armenia	2001	Integrated Living Standards Survey	4,037	1,738	Expenditure
Serbia	2002	Living Standards Measurement Survey	6,386	1,063	Consumption
Romania	2002	Household Budget Survey	32,285	11,053	Consumption
Russia	2003	NOBUS	44,493	25,223	Expenditure
Poland	2000	Household Budget Survey	31,847	20,297	Expenditure
Lithuania	2002	Lithuania Household Survey	3,000	n.a.	Expenditure

In this study, the focus was on the responses of 59,374 households living in urban apartments in five countries of the ECA Region. Almost 50 percent of all households live in urban apartments. Special attention has been paid to ensuring comparability of definitions. For each country, the quintiles were calculated on the basis of expenditure or consumption data. For Armenia, Poland, Russia, and Lithuania, per capita expenditure was used as an income proxy while for Serbia and Romania, per capita consumption was used. The age of the household was coded in four distinct categories: starters (ages 16–29), young families (ages 30–44), mature families (ages 45–59), and empty nesters (ages 60 and over). Four categories of dwelling status of the household were coded

¹⁸ The surveys used here are described in greater detail in the associated poverty assessments, available at <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/EXTPA/0,,contentMDK:20204084~menuPK:443282~pagePK:148956~piPK:216618~theSitePK:430367,00.html> (see Armenia 2004; Serbia 2003; Romania 2003; and Poland 2004). Information about the NOBUS in Russia is available at <http://www.worldbank.org.ru/ECA/Russia.nsf/0/385AA5BB7DB68980C3256E53004B6F14>. The Lithuanian survey is described in Lithuanian Free Market Institute (2002).

¹⁹ For example, second homes and vacancies.

²⁰ The study was performed by the Lithuanian Free Market Institute within the scope of the National Housing Strategy project: http://www.am.lt/EN/VI/rubric.php3?rubric_id=134.

based on the household surveys: owned by the household (1), rented from the state (2), private rentals (3), and free or other (4). For each survey, the four categories were assigned based on the following information (Table 2).

Table 2
Survey Specific Definitions of Dwelling Status

<i>Code</i>	<i>Romania</i>	<i>Serbia</i>	<i>Armenia</i>	<i>Poland</i>	<i>Russia</i>
1=Own	Personal property	Owner	Owned	Ownership of house; ownership of apartment in municipal building or an apartment building, membership in cooperative, ownership; membership in cooperative, tenancy	Your household (privatized, bought)
2=State rental	Leased by state	Protected tenant	State or municipality rented	Rental of apartment—regulated rent; social security apartment	Government or municipal authorities
3=Private rental	Leased by landlord	Paying guest, rents out whole apartment	Private person rented	Rental of apartment—free market rent	Leased from a private person, private legal entity
4=Free or other	Held for free	Lives with no charge in a house one does not own	Other	Subrental of part of apartment; at parents' or other person's; other type of residence	Other form of ownership, difficult to answer

Housing cost primarily included rent, heat, gas, and electricity. The survey in each country posed the questions differently, and in some cases, common utilities might include items that are impossible to separate.

<i>Country</i>	<i>Costs included</i>
Armenia	Rent, heat, electricity, gas
Serbia	Rent, water supply, garbage disposal, central heating, building maintenance, electricity
Romania	Rent, water, sewerage and garbage collection, heat, electricity, other utilities
Poland	Rent, electricity, gas, district heat and other fuels
Russia	Rent, hot water, cold water, heat, gas, electricity

In addition to survey analysis, the study also draws on published census results, official statistics, and data cited in secondary sources.

Rental Housing Supply

Supply Pattern – Volume and Quality

Rental Housing Supply Volumes. Most available official statistics for ECA transition countries deal only with ownership, and not with tenure pattern, although in some cases census includes tenure questions.²¹ A focus on ownership alone tends to systematically under-estimate rental tenure, because of the significance of individual private rental housing, subletting, and sharing. Such data sources are therefore not useful for analyzing the tenure choice and housing needs of young and socially vulnerable households, information fundamental for housing policy formulation.

Analysis by external experts that could identify tenure from census data indirectly is rendered difficult through high barriers to access to the original census data. Barriers include complex administrative procedures, a general lack of public sector transparency, and sensitivity to the “politics” of the results—for example, in terms of ethnic structure in countries where there has been ethnic conflict.

An alternative way to estimate the size of rental housing stock is to look at reported household tenure status, rather than classification of physical dwellings. The survey data reported in Table 3 below show a non-owner-occupied housing sector of significant scale in the case countries. The share varies from 4.3 percent in Romania to 36.2 percent in Russia. The sector is not confined to public rental housing remaining after the apartment privatizations of the 1990s. In fact, the public sector is now surpassed by the combined private rental and rent-free (often against in-kind payment) sectors in Lithuania, Romania, and Serbia. The private rental sector is particularly significant in Poland (16.8 percent of households) and Lithuania (12.2 percent), followed at a great distance by Serbia (4 percent), Russia (3.6 percent), and Armenia (3 percent).

Moreover, in two of the six studied countries the public rental sector is significant: Poland has 30.6 percent rentals, with the private rental sector (16.8 percent) dominating the public rental sector (13.8 percent), and Russia has 35 percent rental, with the public rental sector (31.4 percent) dominating the private rental sector (3.6 percent). Poland did not embark on across-the-board top-down massive privatization, leaving it to municipalities to define and implement their privatization strategies. The country restituted ownership of a substantial volume of prewar rental buildings, and introduced an active, heavily subsidized construction program for private rental apartment buildings and an extended housing allowance program to cover private rental housing. Unintentionally, privatization of public apartments in Russia (31.4 percent of stock) has remained incomplete, as many households have chosen to hold off on executing privatization decisions. The public rental sector is presently marginalized in Armenia, Lithuania, and Serbia and almost eradicated in Romania.

²¹ The decennial censuses in some cases provide better information. The 2001 Armenian census makes it possible to identify tenure status. The 2002 Romanian census included a question on tenure status where the 1992 census did not; however, official analysis of the 2002 census has been incomplete. A positive example is Poland, where census and other housing sector statistics usually include tenure form statistics.

Table 3
Tenure Structure in Studied Countries by Settlement Category

% of households	Armenia				Lithuania*			
	Total	Capital	Urban	Rural	Total	Capital	Urban	Rural
Owner-occupied	92.7	93.6	90.2	94.1	82.6	81.0	n.a.	n.a.
Other tenure	7.3	6.4	9.8	5.9	17.4	19.0	n.a.	n.a.
Public rental	5.8	3.6	8.3	5.5	3.8	4.1	n.a.	n.a.
Private rental	1.5	2.8	1.6	0.4	12.2	13.6	n.a.	n.a.
Free or other	n.a.	n.a.	n.a.	n.a.	1.4	1.3	n.a.	n.a.
	Poland				Romania			
	Total	Capital	Urban	Rural	Total	Capital	Urban	Rural
Owner-occupied	66.4	48.7	56.4	87.8	95.7	94.8	94.3	97.4
Other tenure	33.6	51.3	43.7	12.3	4.3	5.2	5.7	2.6
Public rental	13.8	20.6	20.1	2.2	1.3	1.9	2.0	0.5
Private rental	16.8	27.8	21.6	5.7	1.1	1.8	1.8	0.2
Free or other	3.0	2.9	2.0	4.4	1.9	1.6	1.9	1.9
	Russia				Serbia-Montenegro			
	Total	Capital	Urban	Rural	Total	Capital	Urban	Rural
Owner-occupied	63.8	44.5	62.8	78.7	88.7	88.9	88.7	88.5
Other tenure	36.2	55.5	37.2	21.3	11.3	11.1	11.3	11.5
Public rental	31.4	53.0	32.6	14.6	2.3	2.5	2.1	2.4
Private rental	3.6	1.8	4.0	4.0	4.0	3.6	4.0	4.2
Free or other	1.1	0.7	0.6	2.7	5.1	5.0	5.1	5.0

Source: Table 1.

*Lithuania Free Market Institute (2002).

Note: For Lithuania, “capital” refers to the Vilnius region.

Consequently, there are fundamental differences between the two groups of countries regarding the share of rental segments in the housing sectors. There are also essential differences in the structure of private rental housing. Two countries exhibit substantial private rentals: Lithuania (13.6 percent) and Poland (16.8 percent). In Lithuania most private rental is individual privatized apartments rented informally by their owners. In Poland, a large portion of private rentals are apartment buildings managed by licensed property managers for formal “professional” landlords, who report official incomes and use tax deductions for current and capital repairs.

In some cases it appears likely that the household survey data underestimate rental sector size. One problem is that the number of households that rent privately is so small that even small sampling errors result in large changes in the observed mean. For this reason, it is important not to focus on whether the observed level is exactly 2 or 3 percent, but rather to keep in the mind the relative significance of the observed levels (that is, that there are very few private renters).

Some under-reporting is also possible owing to private renters misstating their status. Reasons could include:

- high levels of rental informality (and sometimes illegality), caused by tax or rent control evasion, which might induce respondents to deny the existence of rent payments or make false claims about ownership;
- confusion about the character of the relationship caused by unclear ownership title, title that conveys usufruct rather than ownership, rental contracts that convey a purchase or cost-free privatization option that has not yet been exercised and is mixed up with ownership;
- unrecorded subletting agreements made by sitting tenants, which may also be unlawful if concerns low-rent municipal apartments;
- heterogeneity in the “free or other” category, where significant number of relationships is likely to imply in-kind payments including labor;
- stigmatization of tenants in an environment of mass homeownership, which might lead to false claims of tenure status;
- sharing of residential dwellings, where two households, often related, occupy a dwelling. By definition only one will be registered as formal owner or tenant, so the other should be deemed as renting, even though without a formal contract and payments.

It is strongly recommended that countries interested in explicit rental housing policies should design systematic and consistent rental housing surveys, to avoid expensive incidental research efforts to distill the required data and information. An outline of such a survey is provided in Annex 2.

Bearing these limitations in mind and considering other data sources and anecdotal evidence allows the following preliminary rapid assessments for each country (Figure 4):

- According to the LSMS, the rental market in Armenia is relatively small at 7.3 percent, of which the lion’s share (5.8 percent) is non-privatized public apartments. Both ratios are substantiated by the 2001 census results. The private rental sector share of 1.3 percent is marginal, considering the country’s share of M-F stock, and likely has a significant element of under-reporting caused by tax evasion and tenants’ confusion about their status. This sector is concentrated in Yerevan. The public rental sector, in contrast, has remained relatively large, since non-privatized stock owned by the central government was transferred to the municipalities. The share is the highest in the earthquake zone of Gumri and Vanadzor.
- The 2002 household survey undertaken in Lithuania by the Lithuanian Free Market Institute²² shows that 17.4 percent the households live in non-owner-occupied housing. A total of 10.5 percent of the households polled live in housing owned by other individuals; 3.8 percent in state-owned or municipal housing; and 1.7 percent in housing units that belong to an enterprise, institution, organization, or other legal entity. These results

²² The survey was undertaken within the work on national housing strategy supported by the PHRD Japanese government grant administered by the World Bank.

appear plausible, given that incentives for tax evasion and hence underreporting were reduced recently. The rental sector is relatively evenly distributed among urban areas.²³

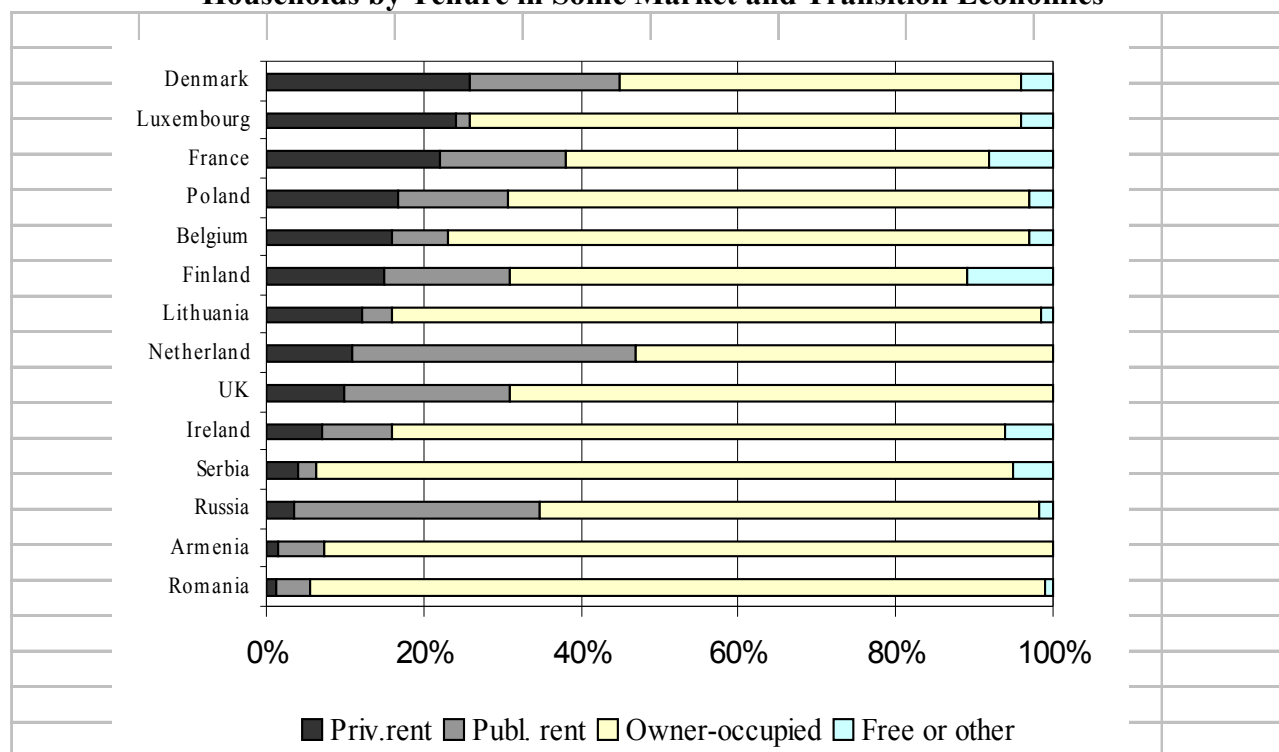
- With an estimate of slightly over one-third of households, the survey arrives at a similarly plausible non-owner-occupied share for the Polish housing market. The 2002 census data indicate a rental sector share of approximately 31 percent, roughly divided equally between public (municipal, state, non-profit TBS) and private (professional, individual, cooperative, and enterprise). Approximately 40 percent of the cooperative housing units in Poland are rented. The professional / formal apartment-building private rental sector is still small (approximately 600,000 units), although it is expected to grow as rent control barriers are removed. The private rental sector is particularly significant in Warsaw (27.8 percent of households) and other larger urban areas (21.6 percent).
- The survey data indicate existence of only a marginal rental sector for Romania of 2.4 percent of the housing stock. This share is supported by the findings of the recent 2002 census about tenure structure among occupied units (although the large number of unoccupied units confuses the picture²⁴). However, high levels of tax evasion and the apparently widespread stigmatization of tenants arising from one of the most radical privatization programs suggest underreporting incentives for households living in rental units. A Bucharest city government survey of 2003 arrived at an estimate of the private rental share of 5 percent, more than 2.5 times the level recorded by the survey data (although in absolute terms the difference is only 2–3 percent). The public rental sector share, in contrast, has plausibly fallen to less than 2 percent of the housing stock.
- Similarly, the survey data are also likely to underestimate the size of the Russian private rental sector (at 3.6 percent). Puzanov (2004) estimates the sector size at about 5 percent; Kalinina and Klepikova (2002) describe private rental as the fastest growing real estate sector in Russia. The widespread tax informality and illegality of most rental arrangements in Russia is probably the largest factor contributing to under-reporting. The tenure status of the large reported public rental stock in Russia is undefined. Current legislation vests tenants with the free “callable” right to privatize, so public tenants can be interpreted as “pending” owners who have not yet exercised their privatization option. However, the new housing legislation recently adopted (the Housing Code) has stipulated a time limitation on these decisions. They would also curb the current practice of tenants in newly built municipal rental apartments privatizing their new units shortly after they get allocated to them.
- The survey data appear to capture well the proportions of the rental sector in Serbia. Official sources suggest a rental sector share among households of 7 percent, of which 5 percent are private tenants. The highest “free or other” share in the sample also concurs

²³ In the region of Vilnius, the non-owner-occupied sector reaches 19 percent, of which 4 percent are public rental and 13.6 percent private rental. These values are not far above the country average.

²⁴ This could explain a part of the large number of unaccounted-for non-owner-occupied housing units that emerged from the 2002 Census. Of the 1.5 million units, only 212,000 are public rental units, leaving a gap of almost 1.3 million dwellings. These units should be vacant (possibly up to 700,000 of them), perform functions as second homes, or be part of the private rental sector.

with official estimates.²⁵ It reflects the effect of numerous war refugees, who frequently live with families or in in-kind rental relationships, and a lack of cash in large segments of the population.

Figure 4
Households by Tenure in Some Market and Transition Economies



Source: See table 1 (ECA countries) and Sak and Raponi (2002).

Unclear Responsibility for Common Property and Shadow Public Rental Sector. The tenant privatization wave of the 1990s left a large number of apartment buildings in the Region with unclear ownership and responsibility with regard to common areas and surrounding land. In many of these M-F buildings, especially those in which public rental units remain, local governments or public utility companies continue to perform the full range of housing management and maintenance services. As a rule, because of a combination of historical bias against maintenance / repairs user fees during transition and the incentive problems of public providers, these services are delivered at insufficient payment levels. At the same time, the public providers cannot claim the benefits that legal ownership of the common areas or surrounding grounds would convey, including the option to evict defaulting users.

Persistent under-pricing of maintenance and repair services, lack of competition among providers, and the common investment disincentives for privatized apartment owners created by often unclear ownership of common areas and surrounding grounds, have all resulted in

²⁵ See Zivanovic (2003).

continued deferred maintenance and increasing physical deterioration and capital depreciation of much of the M-F apartment buildings in the Region.²⁶ The ownership structure of both individual apartment units and common areas and land in the apartment sector seems to be as follows (Table 4).

- In Armenia the remaining public stock is scattered. Likely more than 5 percent of the stock is located in buildings with mixed public-private unit ownership. By 2002 more than 40 percent of urban apartments were in condominiums; however, only half of these are reported to be active in management.²⁷ At least one-third of Armenian housing stock must thus be considered to be in buildings without clear ownership of common areas and land. Reinforcing the perception of continued public quasi-ownership, only a small part of the former public maintenance companies in Armenia has been privatized; in either form they continue to monopolize the maintenance market and provide poor services. Maintenance fees are low and usually set by local governments, which often bow to political pressure from the remaining public tenants and privatized owners.²⁸
- In Lithuania the share of housing stock in buildings with mixed public-private apartment ownership resulting from privatization is unknown. In our judgment, it is likely higher than 10 percent. Only about 15 percent of the privatized units in M-F stock are in buildings that have a condominium form; for the remainder ownership of common areas and land is unclear. Many of these units are reported to be under-maintained and frequently require urgent rehabilitation - especially for energy savings, given the country's severe winters. They continue to be serviced entirely by local governments and public utilities, with the exception of district heating, which has been outsourced under a national management contract in the capital city and few other cities. The limited modernization and rehabilitation programs are heavily subsidized.²⁹

Table 4
Ownership of Apartments and Buildings in Studied Countries as % of Housing Stock*

% of housing stock	Armenia	Lithuania	Poland	Romania	Russia	Serbia
Apartment units	45.2	62.0	71.2	42.8	71.4	29.9
.. in public ownership	5.8	3.8	13.8	1.3	31.4	2.3
.. In private ownership	39.4	58.2	57.4	41.5	40.0	27.6
..in buildings with condominiums	5.9	8.7	5.8	20.7	5.0	n.a.
..in buildings with whole ownership structure*	<5%	<5%	~60-65	<5%	<15%	<5%
..in other buildings	>33%	>50%	<5%	>20%	>50%	>25%
..in buildings with scattered public-private unit ownership	>5%	>10%	almost nil	14.5	36.0	>5%

* Estimated

Sources: Apartment sector size: National Statistical Offices. Ownership status: LSMS, HBS, and Lithuania Household Survey. Condominium status: Armenia, UN-ECE; Morkunaite, R., et al. (2003); Poland, National

²⁶ See World Bank (2004a).

²⁷ See Hamilton and Vecvagare (2003) and Desilets and Vanoyan (2003).

²⁸ See UN-ECE (2004c).

²⁹ See Morkunaite et al. (2003).

Statistical Office; Russia, Ellis (2003). Buildings in other whole ownership structure and other buildings: Author's assessment. Buildings with scattered public-private apartment ownership: Romania, UN-ECE; Russia, Ellis (2003); the authors' assessment.

*Buildings owned by companies, individual landlords, cooperatives, or government.

- Poland is the only studied country where the issue of unclear common area ownership is of less critical relevance, because it was obligatory to form condominium-style homeowners' associations (HOA) at the moment apartments were privatized. The limited privatization activity during transition has led to a heterogeneous ownership structure, including a large municipal and cooperative sector. Legislation also strengthened the incentives to transfer the management of apartment buildings from municipalities to professional property managers.³⁰ The under-pricing of municipal management/maintenance services has been reduced with the privatization of many municipally owned housing servicing companies.
- In Romania, according to government estimates, 34 percent of M-F buildings and 42 percent of high-rise units are reported as having mixed public-private individual apartment ownership.³¹ About half of the apartment stock is organized in condominiums. This leaves at least 20 percent of the housing stock without clear ownership structure for common areas and surrounding grounds. The lack of professional management and low maintenance contributions by owners is a big problem. Maintenance of private condominium buildings and grounds is still in many cases undertaken by public companies at below-cost payments.
- Because of the incomplete privatizations, mixed public-private apartment ownership currently characterizes almost the entire Russian M-F housing stock. Condominiums and cooperatives have been created in only an estimated 7 percent of the stock³²; the ownership of common areas and land in the remainder is ambiguous. Because maintenance has rarely been privatized, local governments spend on average 70 percent of their budgets on housing and communal services, making the owner-occupied sector heavily subsidized and essentially a form of public rental. The situation is exacerbated by large number of entitlements (*l'goti*) granted to numerous population categories in the form of exemptions from and abatements of housing and utility payments.³³ Because cost recovery is still largely insufficient at ratios of about 60 percent, persistent deferred maintenance and insufficient energy conservation measures continue to trouble the sector.³⁴

³⁰ In 1997 Poland introduced a state licensing system for property managers employed in managing residential properties. Other legislation constrained the voting rights of municipalities in condominiums in which they still owned units, thus facilitating a change in property management.

³¹ See UN-ECE (2001).

³² See UN-ECE (2004b) and Skyner (2004).

³³ The government has recently boldly eliminated or "monetized" many entitlements, but left those pertaining to housing and communal services to be tackled later.

³⁴ See Ellis (2003).

- In Serbia, mixed public-private apartment unit ownership is still common because many units remained un-privatized owing to quality or tenant idiosyncrasies. There is no reliable information about the share of condominiums in the apartment stock, but it appears to be rather very low. It is not clear who owns the common areas and land in the largest part of the apartment sector. Large public utility companies, typically owned by municipalities, still provide most of maintenance services as local monopolies, including condominium buildings, in cases where some apartments are still owned as municipal rentals. Municipal building maintenance services are under-priced and frequently cross-subsidized through asset sales and commercial renting.³⁵ Not surprisingly, the level of buildings and ground maintenance in M-F apartment stock has been highly insufficient, resulting in staggering physical deterioration and economic decapitalization.

Skyner (2004) has characterized the Russian stock of apartment buildings with unclear ownership of common areas and land as *de jure* public. Legal analysis in different countries may lead to different conclusions. However, considering the amount of legal ambiguity in combination with the scale of public under-maintenance and other *de facto* ownership tasks still performed by the public service providers, one may assume that a large shadow public rental sector still exists in the ECA Region.

Rental Housing Quality. Is the rental sector marginalized in terms of the quality of housing services provided? There are two central aspects to this question: the concentration of rental housing in the urban apartment sector, and within that sector the selection effects that have led to a specific quality distribution between rented and individually owned (privatized) units.

Concerning the first aspect, the conventional wisdom in the transition countries is that urban apartments, which make up the vast majority of rental units constructed mostly after World War II, are better equipped with amenities than the traditional detached houses of smaller towns and villages. However, the rental sector is caught in the continuing common-area management problems mentioned above that characterize almost the entire apartment stock, which renders the provision of sufficient funds for maintenance and capital repairs difficult. Some of the postwar urban stock in the Region also suffers from well-publicized structural defects and mismatch of unit size, layouts, amenities, and locations with today's demand patterns, which make their long-term sustainability questionable even with proper technical management/maintenance and sufficient ability to pay on the part of occupiers.

The level of apartment stock deficiencies in the studied countries appears profound, in terms of structural defects, deferred maintenance, or dwelling-household mismatches. The findings of recent country analyses are alarming: the Armenian urban apartment stock has been described as progressively deteriorating; many units are physically dilapidated.³⁶ More than a third of Polish apartments are considered structurally defective, of which half are considered ripe for demolition.³⁷ The UN-ECE (2001) report estimates that 80 percent of the Romanian apartment building stock will not survive the coming 20 years, because of structural defects and the results of deferred maintenance. Similarly, UN-ECE (2004b) estimates that 20 percent of Russian

³⁵ For in-depth description of this growing problem see, for example, Ellis (2003).

³⁶ See Desilets and Vanoyan (2003).

³⁷ See Dübel (2004), based on estimates by HypoVereinsbank Polska.

housing stock, most of it in the M-F buildings, needs urgent capital repairs or rehabilitation (renovation). Other sources speak of 40 million persons living in substandard units, with 5 million in units slated for demolition.³⁸

It is instructive to note that as of 2004 in eastern Germany, which may be seen as a fast-forward case of housing sector transition, some 1 million postwar apartment units - 20 percent of the apartment stock - are earmarked for demolition or have been demolished already. The demolitions were preceded by rising vacancies that reduced the investment capacity of the housing companies. Much of this phenomenon was driven by market reasons as households migrated to Western regions and also were given subsidy incentives to buy “greenfield” single-family houses. In some cases even new private rentals were subsidized. This experience indicates that, even with higher individual affordability, much of the postwar apartment housing stock in the Region may become economically obsolete well within its physical life span. Despite individual in-depth country analysis there is still lack a systematic comparative study for the Region that delivers standardized building quality and investment costs assessments and compares them with measures of demand and available public resources.³⁹

Concerning the second aspect, the distribution of quality in the urban apartment stock between tenure forms can be seen as strongly influenced by selection effects that resulted from the speed and scope of privatization to sitting tenants.

- The remaining public tenants are generally found to have not privatized their units because of quality deficiencies and inadequate location, inability to resell or rent the unit, or issues related to their characteristics disqualifying them as owners. This negative selection effect has led to extremely poor residual public rental quality and locations for Armenia, Lithuania, Romania, Serbia, and partly also Russia. A World Bank report (2004) speaks of progressing “slumification.”
- For private rental tenants, we find very diverse quality levels. Adverse quality selection is caused partly by how units come to the market. Quality issues may be exacerbated by the absence of investment incentives, such as rent controls, and by a tax bias against renting. Particularly affected are the un-renovated restituted buildings, which are still rent controlled. However, private rental tenants in the formerly public postwar multifamily stock do not seem to suffer systematically from lower quality housing, relative to owners.

Available evidence also suggests that the limited supply of rental housing available relative to the scale of migrants and young households seeking accommodation has led to crowding in the private rental stock, especially in attractive cities, and helped raise rent levels.

Table 5
Tenure and Crowding in Studied Countries

³⁸ As estimated by Rosstroi in 2004.

³⁹ The EU Commission is focusing its March 2005 meeting of European housing ministers on this aspect.

Per capita figures	Armenia		Poland		Romania		Russia		Serbia	
	Space	Rooms	Space	Rooms	Space	Rooms	Space	Rooms	Space	Rooms
Owner-occupied	10.05	0.62	28.41	1.64	16.73	1.05	15.96	n.a.	24.88	0.95
Public rental	9.59	0.60	20.25	1.33	14.51	0.90	13.62	n.a.	21.81	0.89
Private rental	9.23	0.58	21.40	1.27	17.92	1.04	12.57	n.a.	21.47	0.81
Free or other	n.a.	n.a.	25.04	1.49	18.01	1.09	14.59	n.a.	20.89	0.86

Source: Table 1.

Note: Urban apartment sector. Space is in square meters. Comparable data for Lithuania are not available.

Without detailed rental sector surveys and with inappropriate census methodologies for tracking rentals, it is hard to capture the quality effects with data. However, results have been compiled for the quality dimension of crowding (Table 5). As expected, the Armenian and Russian urban rental stocks are the most crowded, followed closely by the residual public rental sector in Romania.⁴⁰ Tenants in Poland have a considerably larger supply of space and rooms than their counterparts elsewhere in the Region. Owner-occupied units, in turn, are considerably more spacious than rental units.

A more detailed empirical analysis of quality issues affecting the rental housing stock is beyond the scope of this study. However, the situation in Lithuania, which was recently evaluated more closely, may be considered quite representative of the Region.⁴¹ The private rental stock in Lithuania falls into three levels of quality: (i) few hundred units in newly constructed private rental housing for the upscale market, serving mostly foreigners; (ii) larger market for prewar housing stock in inner cities, mostly restituted buildings; and (iii) “retail” micro rental market in the privatized postwar apartment stock. A majority of private renters live in the postwar stock, mostly in small one-room (studio) apartments. According to the Vilnius city government, the remaining 4,000 public rental buildings, all of them in the postwar apartment stock, exhibit “slumification” tendencies.⁴²

Supply Changes – Stock Conversions and New Construction

Existing Stock Conversions

Conversion Mechanisms

At the inception of reform in 1989 there was almost no formal, private rental housing supply in the studied countries. Private rental supply in transition countries was thereafter established through three main conversion mechanisms within existing stock: (i) sublease of privatized or public rental units by individual private landlords; (ii) restitution to prewar owners or their heirs; and (iii) acquisition by landlords on the active secondary market that emerged from massive privatization.

⁴⁰ World Bank (2004a) reports evidence on the positive relationship between per capita space and GDP in transition countries.

⁴¹ See Lithuania Free Market Institute (2002), Morkunaite et al. (2003), and interviews.

⁴² The more or less cohesively public stock is reported to be of poor quality and often in unfavorable locations.

Letting of Privatized or Public Rental Units

Cash income-poor owners or tenants who let their own unit or individual rooms were the first source of private rental supply during transition and continue to play a significant role in the poorer countries. The higher the rental income relative to employment or retirement income, the more active are these subsistence landlords. A 1999 survey of the rental markets in Sofia and Budapest (Lowe 2003) showed that 60 percent of private landlords in Sofia rented out a dwelling originally intended for their own use, while only 45 percent did so in Budapest. The main reason cited for the difference was that cash income levels of landlords were lower in Sofia than in Budapest. Without detailed analysis one can conjecture that these figures could be representative of the studied countries, with Armenia, Russia, and Serbia having the highest share of subsistence landlords.

Restitution of Prewar Property

It is hardly coincidental, though difficult to substantiate with data, that Poland and Lithuania are the two countries most advanced in the restitution process, featuring the largest formal private rental sectors. Conversion restrictions in both countries generally forced the restituted owners to continue renting to sitting tenants, rather than obtain vacant possession of their buildings.⁴³ Countries with slow (Romania) or no (Russia) restitution processes have smaller formal private rental sectors.⁴⁴

Units Bought on Secondary Market for Renting

Secondary market acquisitions have become an increasingly relevant source of private small rental supply since the mid-1990s, particularly in the more established markets of Poland and Lithuania, and to a lesser degree also in Romania and Russia. The initial movement of amateur micro-investors who accumulated portfolios by buying out neighbors gave way to a small private rental industry, sometimes with large individual portfolios of apartments scattered in various buildings. Poland also has witnessed the emergence of an active market for entire private apartment rental buildings and a professional landlord and property management industry in the wake of restitutions of prewar apartment rental buildings.

Private investment in rental assets received an additional push around 2000 when the combination of falling interest rates and high residential rental yields in the Region created more conducive environment. In Lithuania, according to brokers interviewed for this study, the rental supply from portfolios accumulated on the secondary market by 2004 became large enough to put downward pressure on rents. Similarly, in Poland the professional landlord industry continued to grow. The relevance of access to pertinent financing is demonstrated by a result reported in Lowe (2003): in the Budapest-Sofia survey, 36 percent of landlords in Budapest—benefiting from the better developed and subsidized housing finance system of Hungary—bought units with the intent to let them, compared with only 22 percent in Sofia.

⁴³ Although restituted owners were often allowed to reclaim individual dwellings for their family use.

⁴⁴ In an example from non-study countries, Lowe (2003) cites that 12 percent of Sofia landlords rented restituted units, while there was no such source in Budapest, because of the sluggishness of the Hungarian restitution program, which was severely constrained by insufficient court capacity.

Public Rental Supply from the Secondary Market

The secondary market has become an interesting source for new public rental housing supply, which traditionally was limited to new construction and (usually slow) tenant turnover. In Bucharest, owing to limited funding for new construction efforts, the local government has been actively buying inexpensive apartments on the secondary market as a low-cost way to replenish the social housing stock. In a similar effort, Moscow has tried to preserve public stock by halting privatization through inducing new tenants to sign “dwelling use contracts,” which do not legally qualify as tenancy and thus do not confer the option of almost free privatization. Some Polish cities have been buying cheaper cooperative and privately owned restituted dwellings, and are considering the repurchase of privatized units. Anecdotal evidence brings also some cases where privatized dwellings are being offered back to municipalities by privatized tenants to settle arrears and to skip payments due for upgrading and capital repairs. In Lithuania the secondary market mechanism has been enhanced by central government funds earmarked for municipalities to acquire housing for social rental purposes.

New Rental Construction

New Private Rental Construction

Capital cities in transition countries typically feature a very small upscale private rental market served by corporate investors that caters to other corporations, foreigners, embassies, and other high-income clients. Stock conversions often do not produce sufficient quality levels for these clients, in dwelling type, standard, and location. New construction has been active in the largest and capital cities in the Region (Moscow, Saint Petersburg, Warsaw, Vilnius, Bucharest, Belgrade). Other cities have very little or no corporate investment in rental housing so far.⁴⁵ Evidence for new construction activity catering to average domestic households is limited to Poland.

New Public and PPP Rental Construction

All the studied countries except Armenia and Serbia have started new public rental programs in response to the sluggish recovery of housing construction during the transition and to the expanding waiting lists for public housing allocation. Particularly active are Poland and Russia, which both have specific PPP models for rental construction. In Poland, municipal and mixed public-private non-profit rental housing (TBS) construction in 2002 amounted to 8 percent of newly constructed units. In Russia, because of the lack of private urban land, local governments “participate” in the majority of new construction projects, extracting an unknown share of public rental units from developers.⁴⁶ The new construction programs in Romania and Lithuania are small and targeted to certain groups (low income, students). Recently, associations of banks and developers in Poland have been discussing a new PPP scheme, which would produce new rental

⁴⁵ Lowe (2003) reports that 2.1 percent of rental investors in Sofia were corporate investors, and there was no evidence of corporate investors in Budapest.

⁴⁶ Municipalities in Russia control access to land and continue “spot zoning,” which forces developers to relinquish some new dwellings to municipalities in exchange for land access and necessary zoning.

housing by private sector partners, which would be made available to municipalities on long-term lease basis and used by them for social rental housing policy objectives. Municipalities would help mostly in terms of providing access to serviced building lots dedicated to such construction.

Rental Housing Demand

In the tenure choice literature discussed earlier, rental housing demand is seen primarily as a function of income and life-cycle circumstances of the household involved. In the analysis of the studied countries that follows, the focus is on exploring those empirical relations. Other important demand determinants, such as deeper household type differentiations, income risk factors (proxied by professional status), and wealth and access to finance, are referred to future research. A brief review is made of available evidence concerning the impact of intra-country migration and the mismatch of available dwelling attributes and demand. These are the two factors expected to show high empirical significance for the housing sectors in transition; unfortunately, data problems are encountered here, calling again for better census information or in-depth rental housing surveys in the future.

Demand Structure – Life Cycle and Income

Rental Housing Demand and Life Cycle

Private Rental Sector

In the urban economies of transition countries,⁴⁷ the private rental sector is a pivotal source of supply for “housing starters” (Figure 5). These are young single households or couples between the ages of 16 and 29 - and young families between the ages of 30 and 44 with at least one child.⁴⁸ This is consistent with the pattern in market economies.⁴⁹

Poland has the highest share among housing starters with 24 percent, followed closely by Russia, Serbia, and Armenia. Even in Romania, with the smallest overall private rental sector share, 12 percent of starters are recorded as private renters. The high Lithuanian figure of 34 percent could be partly due to the lower average age, as the age bracket definition differs from the rest of the studied countries; however, anecdotal evidence suggests a similar relevance of private rental for young households, as in Poland.

Excluding Poland, where the private rental share is almost invariant over age brackets, housing starters in the ECA Region are between 2.6 and 6.5 times as likely to be private rental tenants than the population as a whole. For such households, subsidized rental housing such as university

⁴⁷ The urban-rural income divergence is very large in these countries—especially Poland, Romania, and Russia in this study—and thus must be cancelled to arrive at meaningful results. Hence, we report only data for urban areas.

⁴⁸ Owing to availability constraints, data for Lithuania are added under a different definition, which yields a lower age average within each category.

⁴⁹ See Chiuri and Jappelli (2000).

dormitories and company housing is available only in isolated cases. Consequently, starters in the Region are relegated to seek rental tenure in the private market, with its frequently much higher rents (see below).⁵⁰

In the category of young families (Table 6 and Figure 5), with household heads between ages 30 and 44, the owner-occupied ratio rises; but still the private rental sector is of high relevance, catering to between 5 and 27 percent of households. Given the likely high degree of under-reporting of private rental status in the surveys for Romania and Russia discussed earlier, one should consider the figures obtained for these countries in all age brackets as their lower boundaries.

⁵⁰ Sub-renting is typically at market rents, while formal renting is often subject to rent controls—or at least to rent review controls, as in Poland.

Table 6
Urban Tenure by Young Households in Studied Countries

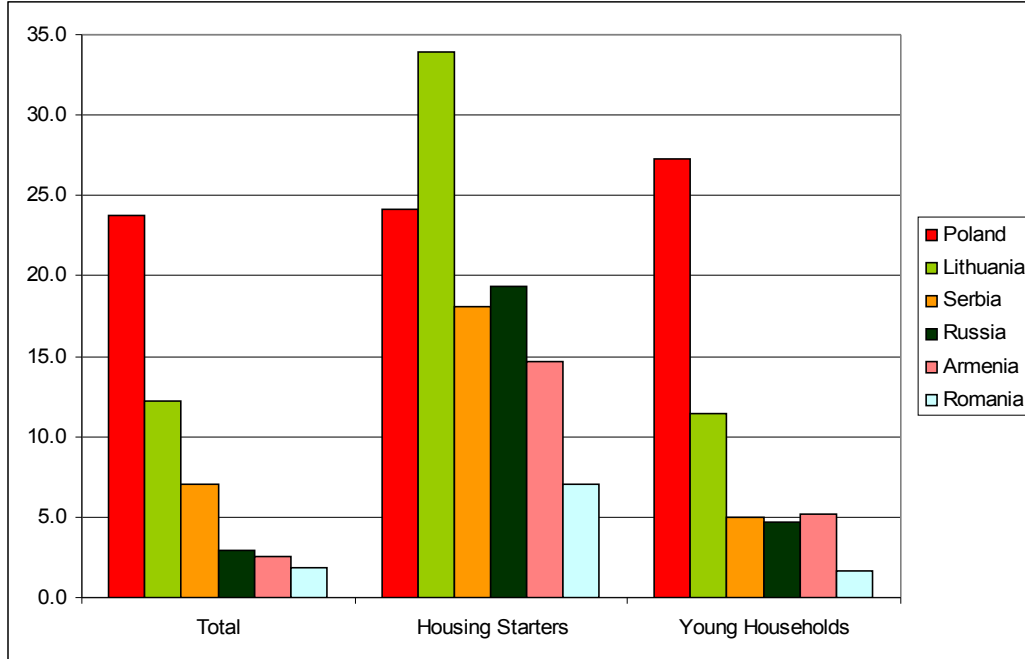
% of households	Armenia			Lithuania*		
	Total	Starters	Young families	Total	Starters	Young households
Owner-occupied	91.6	68.2	85.8	82.6	60.4	83.0
Other tenure	8.4	31.8	14.2	17.4	39.6	17.0
Public rental	5.9	17.1	9.0	3.8	4.0	4.5
Private rental	2.5	14.7	5.2	12.2	33.9	11.4
Free or other	n.a.	n.a.	n.a.	1.4	1.6	1.1
	Poland			Romania		
	Total	Starters	Young families	Total	Starters	Young families
Owner-occupied	55.4	43.9	50.0	95.2	79.2	94.6
Other tenure	44.6	56.1	50.0	4.8	20.8	5.4
Public rental	20.9	32.0	22.7	1.5	1.9	1.8
Private rental	23.7	24.2	27.3	1.9	11.9	1.9
Free or other				1.4	7.0	1.7
	Russia			Serbia-Montenegro		
	Total	Starters	Young families	Total	Starters	Young families
Owner-occupied	56.0	47.7	51.7	84.7	73.9	86.8
Other tenure	44.0	52.3	48.3	15.3	26.2	13.2
Public rental	40.7	32.6	43.1	3.9		5.8
Private rental	3.0	19.4	4.7	7.1	18.1	4.9
Free or other	0.4	0.4	0.6	4.4	8.1	2.5

Source: Table 1.

*Lithuania Free Market Institute (2002).

Note: Urban apartment sector, except Lithuania (entire housing sector). Private rental includes company housing and excludes in-kind and free housing. Age definitions: starters, 16–29 years; young families: 30–44 years (with at least one child). Lithuania Household Survey age definitions: starters, all under 20 years; young households, 30–39 years (regardless of number of children).

Figure 5
Urban Rental in Studied Countries
by Housing Starters and Young Households



Public Rental Sector

In stark contrast to the figures on private rental, the data show that the capacity of the public rental sector to absorb young starter households is highly impaired in large parts of the Region (Table 6). The comparison between Poland and Russia is telling: in Poland, with an actively managed public and public-private housing system (discussed below), starter households are proportionally over-represented in public rental housing and proportionally represented in private rental housing. In Russia, in contrast, starters are both significantly under-represented in public rental housing and vastly over-represented in privately rented housing. Similarly, the public rental sector no longer is significant as a source of housing for young households in Lithuania, Romania, and Serbia.⁵¹

The private rental sector has turned into a significant source of supply for the young - and the most mobile households, while the public rental sector has lost at least part of its policy functionality for such groups. Has it retained its functionality in the income dimension?

⁵¹ In Serbia the survey found no starter households in the public rental sector.

Rental Housing Demand and Income Distribution

Private Rental Sector

Data on the distribution of households living in urban apartments by a suitable measure of income⁵² show that the private rental sector caters to all income groups (Table 6). However, differences can be identified when analyzing individual income groups as follows:

- in Armenia, Russia, and Romania, where private rental supply is scarce, the sector is strongly over-represented - even in relation to owners - in the highest income quintile. Independent evidence from the Lithuania household survey, which does not control for location and type of dwelling, suggests likewise an over-representation of private rental in the highest income quintile. It is somewhat under-represented in the highest income groups in Poland (which, however, has a deep overall private rental sector);
- in Poland, Serbia, and to some degree in Russia, urban private rental sector is strongly over-represented in the lowest income quintile, relative to owners, and even relative to public rental. In Russia, as (see Table 2), private rental sector is also quite large in rural areas, where household incomes are lower. This suggests not only high access costs to ownership, but also an important absorption function of the private rental sector for poor households, which is closer to the pattern in mature market economies.

The interpretation of the data is complicated by the fact that incomes and age are generally correlated over the life cycle, so their effects cannot be separately identified using the current methodology.⁵³ Urban starters and young families, who are over-represented in the private rental sector, are typically richer rather than poorer in the Region, since they generally constitute economic winners of the transition. There are few exceptions: in Armenia, the income distribution is bifurcated - young households are either poor or rich (Table 7). Also, in Poland, outside the largest cities, young urban households are not generally richer than older households.

⁵² In the transition countries, it is useful to replace the concept of household income through proxies such as household expenditure and consumption. This is mainly due to frequent underreporting of income and the significant size of the shadow economy.

⁵³ A probit-logit regression or other econometric techniques that allow for separation of these effects could be undertaken in the future.

Table 7
Tenure and Household Income in Studied Countries

households	Armenia			Lithuania*		
Quintile	Owners	Public rental	Private rental	Owners	Public rental	Private rental
I	20.8	28.3	20.0	n.a.	n.a.	n.a.
II	18.9	16.5	18.9	n.a.	n.a.	n.a.
III	18.9	23.7	22.3	n.a.	n.a.	n.a.
IV	19.2	15.3	13.1	n.a.	n.a.	n.a.
V	22.2	16.3	25.7	n.a.	n.a.	n.a.
	Poland			Romania		
Quintile	Owners	Public rental	Private rental	Owners	Public rental	Private rental
I	9.9	16.4	21.2	8.9	32.9	9.2
II	15.5	21.1	20.6	14.3	25.1	9.8
III	19.5	21.8	21	20	18.4	16.4
IV	24.7	21.3	19.6	25	11.5	21.6
V	30.3	19.4	17.7	31.9	12.2	43.1
	Russia			Serbia-Montenegro		
Quintile	Owners	Public rental	Private rental	Owners	Public rental	Private rental
I	10.9	13.1	17.6	21.5	14.6	27.5
II	17.6	17.8	15	19.2	20.5	20.2
III	20.8	20.9	16	19	24	14.6
IV	23.1	24.1	17.9	19.1	26.6	21.1
V	27.7	24.1	33.6	21.3	14.3	16.6

Source: Table 2.

Note: Urban apartment sector, income proxies (for definitions, see data descriptors in Table 1).

Public Rental Sector

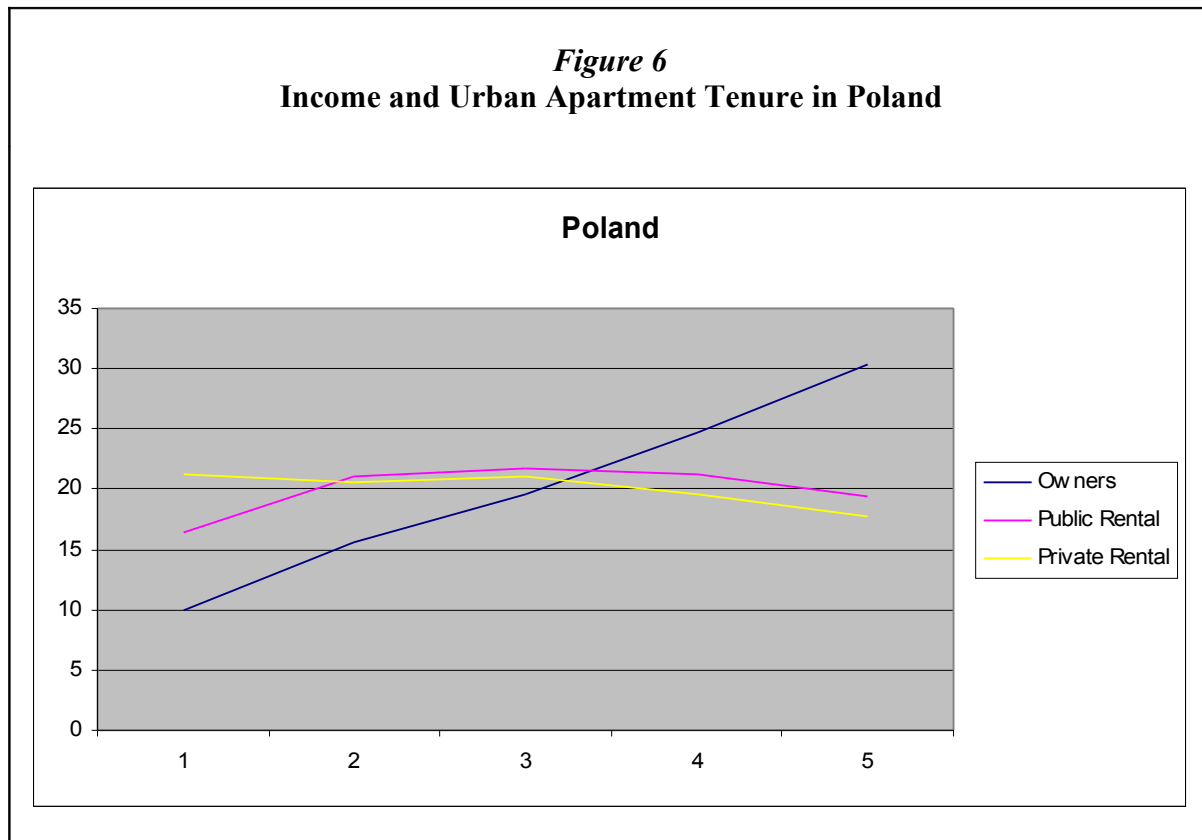
Table 7 reveals that, from a housing policy perspective, the public rental sector's income-tenure share relationship has the right negative sign in only two of the five countries (Armenia and Romania). In Poland (see also Figure 6) and Serbia, middle-income groups are over-represented. In Russia the income profile of public rental tenants is almost identical to that of owners (see also Figure 7). The results for Poland and particularly for Russia are dictated by the residual effect of tenants allocated under socialist rule to dwellings that did not privatize during the transition. In Russia, in the current legal situation, sitting public rental tenants can be considered *de facto* owners waiting to execute their privatization option.⁵⁴ In Poland the non-profit rental sector, which is geared toward middle-income groups (see below), may have caused some increase in the reported average income of public tenants.

In contrast, low-income households in Armenia, Romania, and also Lithuania⁵⁵ are strongly over-represented in the urban public rental sector (see also Figure 8 for Romania). However, this empirical result reflects the sector's marginalization after the almost completed massive

⁵⁴ See Ellis (2003).

privatization rather than an outcome of purposeful public policy. Still, even in these countries some income-rich tenants remain in the public stock and continue to pay very low “token” rents.

Figure 6
Income and Urban Apartment Tenure in Poland



⁵⁵ Data from the Lithuanian Household Survey in 2002 suggest an overrepresentation of both very poor and very rich tenants in the public stock. This is partly due to the relatively uniform distribution of public housing among urban and rural locations. However, anecdotal evidence for Vilnius suggests a concentration of poor clients even in a high-income region.

Figure 7
Income and Urban Apartment Tenure in Russia

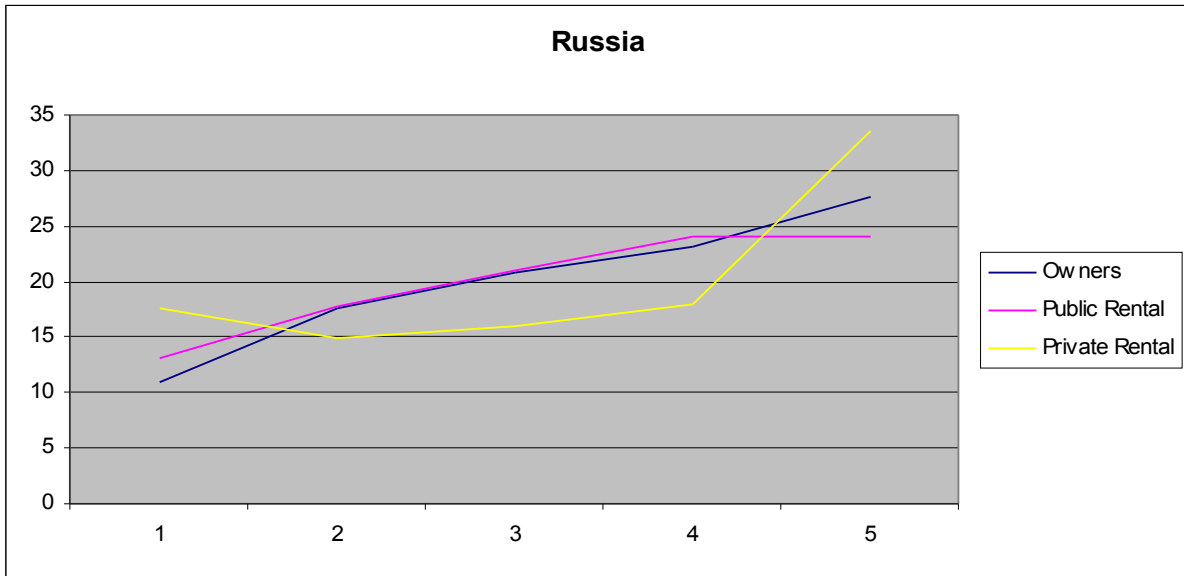
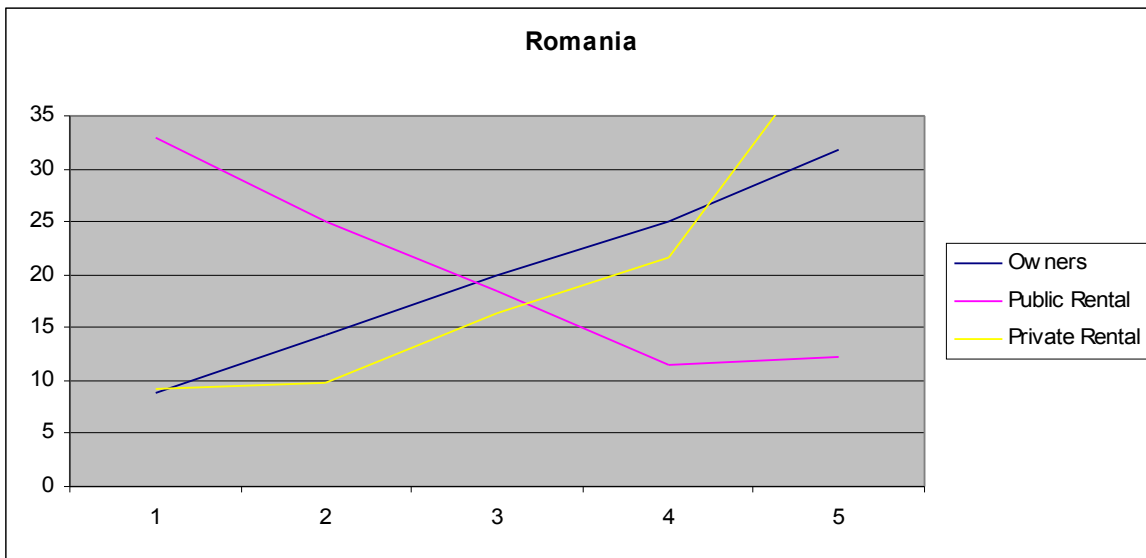


Figure 8
Income and Urban Apartment Tenure in Romania



Demand Changes—Spatial and Social Mobility

Spatial Mobility and Labor Markets

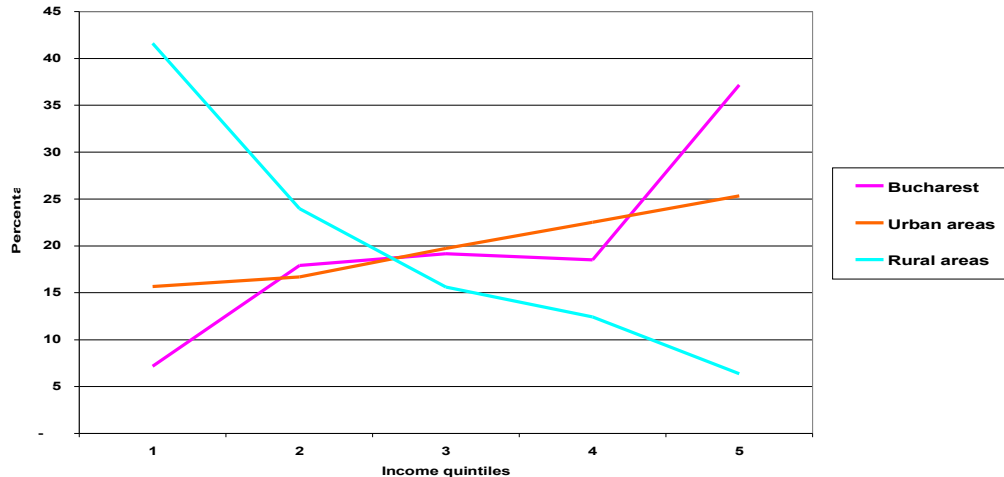
Spatial Mobility / Migration

Does the emerging rental sector in transition economies play the role in migration and labor market adjustment that it conceptually should play? Do the small rental sector sizes observed for some countries bar labor market adjustments and hamper economic growth? Mainstream migration research for transition countries continues to suffer from the weak linkage between the traditional labor market and the hypotheses formulated by the new spatial economics. Migration analysts invariably test for relative wages and unemployment factors but give little consideration to the effects of factors in the non-tradable goods sector. However, some of the analyses for transition countries hold indirect clues to the relevance of the housing sector.

Fidrmuc (2002), for example, finds for Poland, the Czech Republic, Slovakia, and Hungary that net migration between regions has been far less responsive (elastic) to inter-regional wage and unemployment differentials than expected under traditional labor market models. This suggests the presence of some threshold costs of migration that could include relative housing costs.

Kallai (2003) analyzes interregional migration patterns for Romania with explicit consideration of the costs of migration. She observes an unexpected positive correlation between migration and the regional income level for low-income groups. As in the Fidrmuc study, this suggests a cost threshold for migration that distorts labor market adjustment. The differences in income distribution in Romania are stark (Figure 9): the typical monthly rent of a Bucharest apartment, US\$100, is a considerable investment for a dweller in Romania's rural areas. Our data confirm that renting in Romania is essentially limited to the two highest income quintiles (Table 7).

Figure 9
Urban Bias: Income Distribution of Young Families in Romania



Source: LSMS, see table 2

A recent World Bank report (2004a) draws similar conclusions when discussing the low mobility of households in transition countries compared with developed markets. This report uses household survey data to establish that it is mainly households in the highest income quintile and particularly residents of capital cities that tend to move. And anecdotal evidence from various cities gained during this study indicates that almost all housing supply for such migrants in successful regions is provided by the private rental sector, consistent with the experience of mature economies. However, both results can be interpreted in two very different ways: either they suggest a sufficiently large housing supply elasticity in the successful regions to allow for labor market adjustment and growth, or they simply reflect high turnover rates in a supply-constrained (rental) housing market segment with little labor market and growth benefit.

The general scarcity of rental housing, absence of new production, and high rent levels presented in this study provides indirect evidence that in many attractive cities in transition countries housing supply constraints dominate migration, not vice versa. Since rental sector supply elasticity depends entirely on mobilizing existing housing stock, not new construction, the outbidding of sitting tenants by migrants crucially determines total migration activity. Examples for displaced sitting tenants are elderly or other socially vulnerable households that are sufficiently cash income - poor to be attracted to vacate their units, usually against a side

payment.⁵⁶ However, relying on a stock conversion mechanism alone, when new construction is economically not feasible, leads to inefficiency over time: the number of sitting tenants who can be outbid by migrants shrinks to zero. The higher minimum wage level required by migrants to compensate for the resultant rising rents will eventually stop migration.

Analysis from a different empirical perspective supports the perception of housing supply inelasticity. The urban hierarchy - measured by the relationship of a city's rank in the nation to its size - has barely changed during the first decade of transition, which was characterized by significant regional labor market changes. In contrast, city hierarchies changed drastically during the last decade before transition, the 1980s, which was characterized by high housing construction activity levels.

Table 8
City Rank and Size—Little Change during Transition

Year	Poland		Romania		Russia		Serbia	
	Beta	Year	Beta	Year	Beta	Year	Beta	Year
~1980	0.85	1982	0.89	1977	0.77	1979	0.86	1981
~1990	0.80	1992	0.86	1992	0.735	1989	0.85	1001
2002	0.81	2002	0.87	2002	0.735	2002	0.84	2002

Source: Statistical offices, the authors' estimates.

Note: The equation tested is $\ln(\text{city size}) = \alpha + \beta * \ln(\text{city ranking})$. Sample sizes: Poland = 100, Romania = 70, Russia = 109, Serbia = 49. Fit quality: all R^2 greater than 0.95. Armenia and Lithuania are excluded because of low sample sizes. City size is defined by administrative borders, which tends to lead to lower betas relative to wider metropolitan definitions.

Regression analysis is normally used to test an empirical regularity between city size and city rank, called Zipf's Law.⁵⁷ For all four countries analyzed, the 1980s brought certain decentralization, most pronounced in Poland and Russia, while the 1990s brought no change or only a small recentralization (Table 8). Considering the declining relevance of mono-industrial cities and the increasing relevance of agglomeration effects in a market economy, a strong recentralization and closer approximation of Zipf's Law ($\beta = 1$) would have been expected had labor and residential mobility been unconstrained. Deichmann and Henderson (2000) confirm for Poland that rural-urban migration has significantly declined during the transition, despite the fact that Poland is still considered to be under-urbanized. They also point directly to the relevance of housing shortages that might reduce labor mobility.⁵⁸

⁵⁶ In Lithuania, for example, many elderly privatized tenants in Vilnius, who moved to the city after World War II, are enticed by real estate brokers to sell off and return to the much cheaper towns and villages of their childhood for retirement. Their Vilnius dwellings are then sold to small investors for renting out to in-migrants pulled to the city by the strong labor market.

⁵⁷ See Fujita, Krugman, and Venables (1999), Chapter 12.

⁵⁸ Similar problems are characteristic for Russia, where World Bank (2004b, Executive Summary, Page ii) finds that Russia "appears to be 'missing' a sizeable number of large cities (with more than 1 million inhabitants)." (Quotation marks in the original.)

The main thrust of counteracting policies would be to increase rental supply elasticity, through either new construction activity or more systematic stock mobilizations as a result of rent decontrols and the like. In particular, deeper liquidity of the rental market would be pivotal: it would not only allow the successful region to avoid the cost-induced wage wedge that blocks migration, it would also minimize the social imbalances associated with dislocating sitting tenants.⁵⁹

Social Mobility and Filtering

Social Mobility / Filtering

Is there empirical evidence that the rental sector in transition countries starts to fulfill its function as a mechanism of adjusting housing consumption to income levels through a chain of moves? Data for assessing this question even superficially are missing in this introductory study, but the issue should be addressed in a follow-up study. An educated guess at this stage would be that the private rental sector, albeit often very small and expensive, is beginning to fulfill a considerable function in the filtering / moving chain. The function is still mostly on the receiving end, as the sector has expanded with the number of migrating households. Restitution and secondary market transactions have already led to a filtering down of a significant amount of older apartment units to the urban private rental sector. Also, in countries with developing mortgage markets in the Region (in our sample, Poland, Lithuania, Russia, and Romania), a growing number of young households are upgrading from the private rental sector to ownership, considerably assisted in some cases by mortgage subsidies.

The public sector housing stock, by contrast, seems an anomaly. The classical predictions of filtering theory suggest that public rental carries few or no price incentives to relocate for households with rising incomes because of its low rents, which lead to excess consumption of space. In the studied countries, the presence of extremely low public rents is indeed a fact. However, it is unclear whether, despite such low levels, rents are generally subsidized, since investment in public units is extremely low, too. As a result, higher-income tenants face an intolerable loss of housing utility, in some cases “slumification,” when they remain in the public stock. In most parts of the ECA Region, except those with very scarce housing, higher-income households are leaving the deteriorating neighborhoods, with their heterogeneous social-economic mix, to settle into newly developed or gentrified older housing areas that are more socially homogenous and segregated.

How much the dynamics of the filtering process of public units depend on the elasticity of demand created by the interaction with the private rental and the homeownership / mortgage sectors and public sector investment strategies can be studied by comparing the cities of Vilnius and Bucharest:

- In Vilnius public rental housing has been marginalized through privatization. The private rental sector is the only remaining receiving sector for young households and migrants.

⁵⁹ Some of the relationships between labor and housing markets described, including references to Western EU countries, are expected to be examined in the upcoming Bank study on labor mobility in the new EU member states.

Rents in Lithuania are decontrolled, and access to mortgage finance at very low rates creates effective demand for higher-income owners or tenants for filtering-up purposes, adding to rental housing supply and greenfield detached housing construction for owner occupation. In this elastic supply, responsive environment, public units have progressively “slumified.” In a belated response, the recently adopted National Housing Strategy calls for an explicit government social housing program. However, given low economic demand or remaining tenants and the level of decay, many public units cannot be economically modernized and will have to exit the market.

- The private rental sector in Bucharest suffered from much greater policy and market constraints in the past, including legislated rent controls on restituted properties and the complete lack of mortgage finance in a high-inflation environment. This put severe brakes on the creation of new housing supply, even though the city has land reserves, pushed rents upwards, and so far kept the social mix in the remaining public units. As the mortgage markets began to develop lately, tenants or owners of moderate or low-quality housing are receiving modest relocation incentives. The Bucharest city government is banking on this filtering-up effect by setting up a program to purchase vacated housing units cheaply, to re-create a public rental sector. Although these units are usually of low quality, they have not yet slumified because of sufficient remaining demand. A public investment strategy, however limited in financial resources at the moment, appears promising.

The Romanian example also shows that public housing policy in transition faces a dilemma between accepting lower-quality units or reaching a smaller market. Poland has tried to strike a compromise in that regard by promoting non-profit PPP rental housing (TBS), inspired mainly by the French social housing program HLM (Habitation à Loyer Modéré). The program was partly a response to obstinately high mortgage rates in the late 1990s, which implied prohibitively high down payments for middle-income households. The TBS system provides filtering-up incentives for these households: it offers a large improvement in housing utility relative to municipal stock through providing new rental units, but also requires beneficiaries to deposit “key-money” down payments and pay higher-than-usual rents. Old units vacated by new TBS dwellers will filter down, typically to the private rental market. While the general logic of the program is appealing - tapping private demand in a PPP model while generating low-cost units that filter down - the program appears excessively subsidized (see discussion below).

Rent Levels and Affordability

Private and Public Rent Levels

Does the rental sector in the Region make a contribution to more affordable housing? Private rental markets in transition countries are sharply divided into the small upscale market catering to corporations and foreigners, and the “popular” market for domestic tenants. We are mainly interested in the popular market in addressing this question.

Both private and public sector data are hard to come by for this market.⁶⁰ Evaluations of new contract rents start with surveying rental ads and broker listings or holding interviews. Anecdotal evidence from such sources obtained during the study indicates new contract rents for one-room (studio) apartments starting from US\$50 per month in Yerevan (Armenia), through US\$100 in Vilnius and Bucharest, to US\$250 in Warsaw and Moscow. More representative analysis in this direction was beyond the scope of this introductory study.

Table 9

Rents, Rent-to-Income and Cost-to-Income Ratios in Studied Countries

	Armenia	Poland	Romania	Russia*	Serbia
Rents in LCU					
- public	11000	154	200188	381	nil
- private	15044	124	799487	646	4645
Private/public	136.8%	80.5%	399.4%	169.6%	n.m.
Rent-to-income**					
- public	23.1%	8.3%	4.7%	5.7%	nil
- private	27.1%	7.3%	8.9%	9.7%	18.8%
Private/public	117.5%	87.7%	188.1%	172.4%	n.m.
Housing costs-to-income***					
- owners	11.0%	n.a.	13.2%	17.4%	9.1%
- public rental	34.3%	n.a.	16.8%	17.6%	10.1%
- private rental	35.5%	n.a.	21.6%	19.4%	27.6%
Private/public	103.4%	n.a.	128.9%	110.1%	273.4%

Source: Table 1.

Note: Urban apartments only, housing bill excluding energy/heating.

**Average rent payment divided by average income proxy value.

***Average housing costs (rent/condominium fees + utilities) divided by average income proxy value.

However, the results from the surveys (Table 9) provide a useful snapshot of average existing contract rents in the popular market. Since rent levels are derived from interviews with sitting tenants holding seasoned contracts, they reflect different contract originations (vintages) and will

⁶⁰ Brokers and investment advisers offer rent information for the upscale market. This segment is left out of the study, as it is characterized by very specific and not representative supply and demand conditions.

differ from current new contract rent levels. The difference between new and existing contract rent levels will be influenced by locally specific tenure durations and the presence or absence of rent controls. However, in cross-country comparisons, average rents do not seem to go too far astray from the anecdotal data on new rents.

The exception is Poland, which is the only studied country exhibiting both lower private than public rents and significantly lower average rents than marginal (new contract) rents (Table 9). Private rents reflect a market-mimicking grading scale used by many municipalities for calculating rent ceilings below the overall ceiling of 3 percent of replacement costs, set by the central government. These grading scales are set less sensitive to location factors and more sensitive to the physical conditions of apartments and their buildings. Since the restituted prewar private rental stock is typically in worse physical condition and has fewer amenities and lower standards than the postwar municipal rental stock, the grading scales result in the lower average private rents.⁶¹ This will be changing, however, with new regulations allowing substantial rent increases in this rental stock.

In the uncontrolled markets of Romania and Russia, in contrast, private rents are both significantly higher than public rents and less affordable. Although distorting factors in the LSMS and HBS is a possibility - for example, strategic behavior of interviewees to conceal true rent levels because they might violate regulations or lead to higher taxation - we believe that these results by and large reflect the low quantities of rental housing supply in those countries determined earlier in the chapter.

- The data for Romania confirm our evidence on the scarcity of rental housing supply -especially in Bucharest. According to our interviews, for example, flats in public rental units in Bucharest in 2004 were let for just one-tenth of the rent level in the private market.
- The data for Russia indicate somewhat lesser relative scarcity of private rental units than in Romania, but certainly still yield a high differential. This is consistent with both the findings of a low base effect concerning sector size reported in this study and the dynamics of new rental supply noted by Kalinina and Klepikova (2002).

The countries of Armenia and Serbia are both in special situations:

- The low mark-up for private rents in Armenia seems to reflect the combined effects of a lack of effective demand and a lack of net emigration, which leaves many units vacant. Low general affordability makes public rents appear very high - which they are not, if compared to costs.
- Serbia has by definition the highest mark-up of private rents, because our survey does not record rent payments made for public rental apartments.

It would be worthwhile to refine the results obtained by the LSMS and HMS by location or available information reflecting housing quality and tenant income. Such a hedonic pricing approach would lead to a greater accuracy about whether the matching of pricing and incomes

⁶¹ Although newly agreed contracts in these buildings, on vacated dwellings, are released from this rent setting regime.

works. Also, tracing rent levels over time would be important to test the interaction with the improving mortgage market conditions. However, the data presented here seem to provide an accurate snapshot of overall demand and supply conditions.

Household Effort Ratios for Housing Expenditures

Quite expectedly, our results indicate that households' rent-to-income ratios are significantly higher in the private than in the public rental sector, with the exception of Poland. The gap for Romania is reduced somewhat by the fact that private tenants have higher average incomes than public tenants. For Russia and Armenia, the affordability relations reflect the price relations. Gaps between private and public rental are reduced when considering energy costs. In Russia, for example, heating cost-to-income ratios for public tenants (at 4.6 percent) are significantly higher than for private tenants (3.8 percent). The effect is similarly pronounced in Romania. It must be left unresolved at this stage, whether private rental tenants simply spend less on heating, or whether their units are more energy efficient. Statistical errors typical for small sample size are a possibility, too. Additionally, rental contracts may include utilities within rental amounts. Armenia and Serbia - the two countries with the highest poverty evidence among the studied countries - show the highest absolute rent-to-income ratios for private rental units.

Relative to income levels, private rental housing tenure throughout the Region is considerably less affordable than "privatized" ownership, which gives a clue of the size of the windfall - at least in current cash payment terms - that sitting tenants were given through the privatization. However, private rental is still relatively affordable compared with urban rent-to-income or housing cost-to-income burdens in Western Europe, where effort ratios of 15–20 percent (net of energy and heating) are typically found. Public rental housing is generally very inexpensive relative to income—with the exception of Armenia, for the reason discussed above - and most affordable in Romania and Russia.

Affordability and Profitability of Renting

The findings on affordability seem to be at variance with popular notions of the high profitability of informal renting (Box 1). The perception of highly profitable private rental entrepreneurship in the Region is biased toward cases of metropolitan cities with extreme demand conditions. Such perception problems are exacerbated by the stories of tenants in new municipal apartments who can quickly privatize, turn around, and sublet their units at market rents.

Considering the survey data that reflect broader urban area definitions and landlord categories, and contrasting current rent levels with investment return requirements, the picture of high profitability softens considerably. Lithuania may be more characteristic for the rental profitability trend in the Region: according to brokers interviewed, rents in Vilnius have been stagnating since about 2001, owing to an increasing supply in both the upscale and the popular rental markets. Apartment prices nevertheless have risen, fuelled by the expanding mortgage market that experienced falling interest rates and generous homeownership subsidies. In combination with rising prices and stagnating rents, private rental yields have dropped.

As mortgage markets in the Region have started to swiftly expand, broadening homeownership affordability, filtering up into the owner-occupied market should steadily increase. The combined effect should soften the profitability of renting for some time to come.

Box 1
Informal Renting in Russia

A recently privatized owner in a typical Russian apartment block is paying the municipality an equivalent of \$50 a month. This is composed in 80 percent of utility payments, 50 percent of that for heating. The residual 20 percent is paid as a maintenance fee to the municipal housing management company. Most of that is a subsidized user fee, and only a tiny fraction is charged as a pure rent. Once the owner turns around and rents the apartment to a private tenant, the rent rises to US\$400 a month, with the owner still paying US\$50 to the municipality, while receiving the difference, US\$350, as a profit. This calculation is free of taxes, since this economic activity is not reported as taxable income and tax authorities are not pursuing these incomes. The relationship between utility payments and rent now become more comparable with the economic rental model found in mature market economies, where rents are significantly higher than utility payments. In this instance utility payments constitute only 10 percent of total housing costs, as compared with 80 percent in the municipal social housing framework.

4. REGIONAL TENURE CHOICE POLICIES

Rental Housing Investor Categories

Developed rental markets are characterized by a mix of private “amateur” typically informal, private “professional” typically formal, and public rental housing investors. Scaling up capacity by motivating a variety of investor types with different management and financial structures has been a key mechanism for generating investment in those markets. The policy analysis begins by identifying the main investor categories in the studied countries and analyzing their economic incentives and disincentives.

Private Amateur Investors

Subsistence landlords are typically cash income-poor owners or tenants, frequently unemployed or retired, renting out their own unit or individual rooms in it.

Restitution beneficiaries exhibit very heterogeneous cash income status. Given the restrictions of restitution laws in transition countries, which generally exempted or capped restitution of large estates, portfolio size is typically limited to a single or few buildings. Often, beneficiaries are heirs of prewar owners who exhibit heterogeneous interests. Tenant protection legislation forced them to become rental landlords by taking over tenanted buildings.⁶² Frequently, the restituted rental units are sold onward to small private landlords or to professional landlord-investors.

Small private landlords are usually cash income-rich and accumulated small portfolios on the secondary market for privatized apartments during the period of low and moderate prices in the early 1990s, for trading or for generating investment and retirement income. They include restitution beneficiaries who grew organically into portfolio investors. Such investors typically own small numbers of dispersed dwellings or, less frequently, whole rental buildings, purchased from restitution beneficiaries.

All three investor categories are typically part of the shadow economy in the studied countries, operating informally from the tax perspective and often even without contracts. An exception is Poland, which has a low degree of tax evasion (see below). A “passive” small private landlord market investing for tax shelter purposes, very active in many Western European countries, has not yet emerged to any significant degree.

Private Professional Investors

Emerging from the two previous categories, professional private landlords have appeared in the more advanced markets in the Region (Poland and Lithuania in the study). They hold mid-sized rental housing portfolios for permanent investment and current income generation. The main group of professional landlords chooses the legal form of a small business, such as a sole proprietorship or a limited partnership, to limit liability and secure the ability to deduct capital

⁶² Typically, restitution allows the beneficiary to claim vacant possession of some apartments for family use.

costs from rental revenue under the corporate income tax code (where this is allowed). Such investors usually bought inexpensive units at the secondary market with their equity funds.

Rental housing and hostel accommodation provided by employers is also a relevant sub-sector in Russia, where natural resources companies and the national railroad company continue to provide housing on an extensive scale. The “landlords” in these cases are mostly private corporations that for tax purposes net out losses from renting against other profits.

Institutional investors in the rental sector hold properties for permanent investment purposes and often also develop property themselves. The small market consists usually of domestic construction companies that gradually evolve into property holding companies, sometimes in joint ventures with international investors, operating under the corporate income tax code. Box 2 provides examples from Poland and Russia. Institutional ownership of residential properties by insurance companies and pension funds is still largely unknown. In the professional market, rental contracts mostly exist and are submitted to the tax offices. Formality is particularly important for contracts with corporations or with foreigners as tenants, who seek both legal and tax protection and typically use brokers that offer standardized contracts.

Non-profit and Public Investors

Non-profit rental. Non-profit (or limited profit) rental investors include housing cooperatives, charities and churches, and PPP models. Cooperatives concentrate in the postwar urban stock while charities and churches are often beneficiaries of restitution of older stock. Public-private partnership models are relatively new and deal with the construction of new apartment stock. The tax treatment of these investor types is quite heterogeneous, even in mature markets. Although a full survey was beyond the scope of this study, it appears that members of cooperatives in the Region tend to be taxed solely under the personal income tax code for rental revenues (usually of their individual units, rented out with the consent but not the economic involvement of the cooperative), while charities and churches are often tax free. In the PPP model of TBS in Poland the municipality, as the public partner, may remain the owner for legal and tax purposes, until property ownership is transferred to the user after 15–20 years. Other variants of TBS may see private partners dominating the ownership structure. The TBS lessor signs formal leases, while many cooperative members renting out their units do not.

Box 2

Emerging Institutional Investor Market in Rental Properties

First efforts an institutional investor market in income-generating residential properties were observed in Poland, where the state insurance company PZU has formed a real estate subsidiary to hold and develop income-producing properties. In Moscow the main corporate developer is UPDK, which grew out of the Soviet-era company that used to service the residential needs of the diplomatic corps and other foreigners. The company was privatized with sufficient asset and financial resources, allowing it to make rental building investments, which take years to return the capital invested. Still, given the tight market, the UPDK is charging very high rents, which allow for a faster return of capital.

Public rental. After the privatization and “communalization” waves, the public owners in the Region are today overwhelmingly local governments.⁶³ Public companies, which are now incorporated and taxed as corporations, have also remained owners of apartment stock.⁶⁴ Public owners have generally retained the government-built, postwar, often large-panel, prefabricated housing stock. Rental contracts in the public sector are in writing and are subject to taxation (for example, corporate taxation in the case of public incorporated companies). However, in countries with marginalized public rental stock, rent evasion is frequent and often occupants are not even registered.

Table 10
Rental Investor Categories and Activity Levels

	Armenia	Lithuania	Poland	Romania	Russia	Serbia
Subsistence landlords	Very active	Active	Active	Very active	Very active	Very active
Restitution beneficiaries	Active	Very active	Very active	Very active	Active	Active
Small private landlords	Active	Active, including leveraged	Active, including leveraged	Active	Active	Active
Small businesses	None	Active, including leveraged	Active, including leveraged	Active	Active	Active
Employer	None	Small market	Small market	Small market.	Significant market	None
Institutional	No institutional construction	Some new construction in major cities	Active new construction in major cities	Active new construction in Bucharest	Some new construction in major cities	Some new construction in major cities
Non-profit rental	None	None	Very active (TBS)	None	None	None
Public rental	Inactive (small sector size)	New construction program	Almost inactive	Small sector	Active	Inactive
Debt investors	No lending	Lending to small private landlords	Lending to small private landlords, PPPs, and institutions	Lending to small private landlords starting	Lending to small private landlords starting	No lending

Source: The authors’ assessment based on literature review, information from market participants, and LSMS/HBS results.

⁶³ Through communalization state housing was typically transferred to municipalities, which then decided on the extent of privatization (if allowed by law) or which carried out state-mandated privatization (if imposed by law).

⁶⁴ Especially natural resource companies in Russia.

Financial Leverage Investors

Private (mortgage) debt / leveraged financing of rental projects is available in the Region through bank lending to professional private landlords, especially in the fast-growing mortgage markets of Lithuania and Poland, and increasingly in Romania and Russia. Most mortgage lenders, owing to lack of experience, have not yet started to differentiate their underwriting between investment⁶⁵ and owner occupation, which should imply favorable initial interest rate conditions for leveraged investors of income-producing real estate. Some, however, have begun to look at rental projects proposals as part of commercial lending through their corporate departments rather than through residential mortgage lending. Mortgage finance plays a significant role in Poland, where both cooperatives and the TBS system have access to long-term loans for financing new construction with public guarantees. There is still very little public financing in the residential sector, with the exception of a few international open property funds active in the main urban centers in upscale apartment construction.

Table 10 summarizes the assessment. Interpreted jointly with our LSMS results presented in Table 3 it suggests that greater professionalism and activity of private investors develops in tandem with the size of the private rental market. An important determining factor for both to which we turn now is the legal, regulatory and tax framework for rental investment.

Legal, Regulatory, and Taxation Frameworks

Governing Laws and Regulations

The civil code is typically the main source of law governing contracts, including specific provisions on rental agreements. In the studied countries, however, specific sections on residential rentals exist only in Lithuania, Poland, and Russia. The Armenian, Romanian, and Serbian civil codes either do not contain relevant sections or make only cursory reference to rental relationships.⁶⁶ Because of the undeveloped legal framework, most private rental relationships are governed by contractual provisions, with recourse to common courts in case of dispute. Needless to say this way of regulation is quite inefficient, protracted and uncertain.

Contract Establishment, Terms, and Enforcement

Intermediation, Formulation, and Recording of Rental Agreements

In the low- and middle-income rental market, the predominant intermediating mechanisms are newspapers and the Internet.⁶⁷ Rental housing brokers are rather infrequent in this market, as are formal individual contracts. Nevertheless, Lithuania, Poland, Romania, and Russia have active residential broker markets, which cover rental dwellings. Rental brokers serve typically the upscale private rental market for such clientele as young professionals, managers, and foreigners. Given the typical short lease terms, brokerage fees are between one month's rent (Lithuania,

⁶⁵ The terms "private" and "public" in relation to debt investment refer to the tradability of the claim rather than the identity of the holder of the claim. Bonds are public debt, while loans are private debt.

⁶⁶ For more information see Annex 1.

⁶⁷ Rental housing demand is mostly expressed by young households who prefer using the Internet.

Romania) and half a month's rent (Poland, Russia). Only in Poland are real estate brokers licensed after having completed a considerable course and practice work and having passed both written and oral exams, and they also need to be insured. International brokers, who are active in Lithuania, Poland, Romania, and Russia mostly in office and retail markets, are gradually entering the upscale residential rental market. Residential brokerage in Serbia and Armenia is still in its infancy and largely informal.

The civil codes generally require written forms for longer-term contracts, and sometimes for all rental contracts.⁶⁸ In practice, with the preponderance of subsistence and small-scale landlords, contracts are overwhelmingly either in oral or rudimentary written form. Brokered contracts, however, are usually in writing, mainly to protect the broker's fee. Brokers also provide third-party legal advice services to landlords and tenants on contract formulation. However, this does not imply any additional step of legalization.

Various ways are used to record the existence of a rental relationship. The main purposes of formalization are legal security for both parties to the agreement; evidence about the existence of the agreement for third parties, such as banks; and compliance with duties imposed by the government, most notably rent and income taxes. There is only anecdotal evidence on the level of formality in the studied countries. Using taxation as a formality indicator, contracts are generally informal in Armenia and Serbia, as well as for subsistence landlords in the remaining countries.

There is no universal trend toward formalizing contracts. Anecdotal evidence for Russia suggests that an increasing clampdown by the tax authorities on tax evasion has led landlords to avoid and even destroy written rental contracts that could serve as evidence. In contrast, after the reduction of the rental tax rate in Romania, anecdotal evidence suggests increasing formalization there.⁶⁹ Similarly, Lithuanian landlords have reacted to more favorable tax treatment with increased registration. In Poland there is both an informal market with unreported micro rentals and a significant number of landlords of formal rental apartment buildings, which are tax registered.

Rental Definition, Term, and Deposit

Market practice indicates the use of security deposits in the amount of one to three months' rent, depending on the contract term (not regulated in the studied countries). The Polish civil code gives landlords a statutory right of pledge on movable objects in the apartment belonging to the tenant, which is a quasi-deposit. Public landlords in the Region typically require nominal security deposits in their public rental contracts.

Given the scarcity of regulations there is a sharp distinction between private and public rental arrangements concerning lease terms. In private rentals they are typically short—between 6 and 12 months, with rollover extensions subject to mutual agreement.⁷⁰ Often, however, tenants are protected by the right of extension over potential new tenants, or shielded from rent increases during roll-over (as in Poland). This protection holds only for formalized rental agreements,

⁶⁸ Lithuania and Poland: for contracts longer than one year; Romania: for all contracts.

⁶⁹ Because of stronger controls by tax authorities and an improved level of legal security provided to the landlord, through registration with the tax offices, in case of title dispute and litigation.

which partly explains informality. Public lease terms are usually permanent or fixed term, as determined by law (Lithuania, Romania: five years), subject to review of eligibility criteria (Romania: income).

As in the case of mortgage finance, the economic value of the term of the lease for the tenant depends on the capacity of the landlord to review rents during the tenancy. Short contract maturities give the landlord an option to limit such market risk in an environment of economic and - as far as the private rental sector is concerned - additional legal uncertainty. Longer lease terms have therefore only recently become popular, as both the macroeconomic and employment situations have improved (especially in Romania and Russia).

In the private rental sector, triple net rents (net of maintenance, heating and utilities) are the standard in the studied countries. The civil code in Russia forces the formal tenant to pay utilities directly in case of formalized renting. However, utility and heating providers often refuse to deal with the credit risk for short-term tenants and charge the owners and/or managers, who in turn charge the tenants at the end of the month. This may lead to complications; in Romania and Lithuania, for example, the owner must prepay the tenant's telephone bills, raising considerably the credit risk for the landlord. By contrast, while utility payments in Romania are typically made by the landlord, in Lithuania they are typically made by the tenant (other than phone bills).

Notice and Sale

Legislation in the studied countries generally allows for only one-month notice periods for term contracts for both landlords and tenants, which is in line with informal market practice (Lithuania, Poland, Russia). Permanent contracts, however, can be terminated by landlords only subject to special circumstances, with typical notice periods for the tenant being three months (Lithuania). Public rental contract termination is generally defined by pertinent regulations.

A legal principle widely held in Roman law determines that a sale does not break a lease. This principle is incorporated in civil code rental provisions in the studied countries, although in Serbia, some legal uncertainty remains. The Lithuanian civil code leaves tenants with unregistered or verbal contracts unprotected. However, tenants may take a change of ownership as a special ground for giving notice.

Payment Default and Enforcement

Rent payments in the popular micro-rental market are usually made in cash, which raises payment security and technical default issues. Wire transfers and bank deposit payments exist in exceptional cases at the high end of the market in the Region; in Poland and Lithuania it is more common practice. In-kind payments are allowed by several civil codes and seem to be practiced in the poorer countries of the study (Armenia, Serbia).

Where formally regulated, arrears and eviction procedures are similar to the treatment of defaulting mortgage borrowers. Mortgage enforcement has been the subject of frequent reviews

⁷⁰ This market result resembles the traditional Anglo-Saxon rental contract, which still dominates the United States and large parts of the rental sector in the United Kingdom, and has been confirmed through decades of common law practice.

(in the literature) and political initiative for change. Civil codes define rent defaults after two missing rent payments (Lithuania, Russia). Arrears penalty payments are often found in formal rental contracts, but their enforceability is not clear. In practice, the enforcement of arrears payments is very difficult in the public sector. Eviction possibilities often exist under one law (civil code, housing) and are disallowed by another law (social protection). Where eviction is possible, a court order is generally required. This allows tenants to use delaying tactics and imposes high management costs on landlords. Court rulings often require that a replacement dwelling be offered (by the municipality), which defeats the purpose of eviction and puts additional strain on municipalities that have lost most of their social housing stock through privatization and are still grappling with long waiting lists for social housing.

Where legislation exists in the Region, the only defined conflict settlement mechanism is judicial. None of the countries reviewed has an extrajudicial, low-cost arbitration or mediation mechanism such as ombudsmen, rental tribunals, or quick claims courts.

Rent Determination

Rent Determination for New and Existing Contracts

In all studied countries, rent levels for new private contracts are in practice determined by negotiation. With the exception of Poland, however, legal uncertainty about the lawfulness of this practice remains significant. Natural tenant fluctuations (migration, death, acquisition of a flat or single-family house) have created an increasing number of “new” contracts in a legal sense. Although there is no explicit survey data, anecdotal evidence from Cracow (Poland) suggests that by 2004 most private rental contracts were not more than 10 years old.⁷¹

Because of the lack of specific rent legislation, and beyond the legal caveats made above for new rental contracts for Romania and Poland, contracts in the private rental sector have also not become specifically protected. The important exception is the case of restituted properties, sometimes referred to as “denationalized” housing. In all the countries reviewed, restitution programs of varying scope took place and occupiers in restituted buildings were given tenant status. Usually, the privatization laws predated the restitution laws, giving legal title to the occupiers’ tenancy claim and the right to the same rent levels as in municipal rental housing or special rent control regimes (Romania).

Contrary to the private rental regulations, public rent setting usually differentiates between new and existing buildings rather than between new and existing contracts, which are treated in a homogeneous way. Some new public rental construction has taken place, which has led to various ways of setting the rent level. One way is to mix investment costs and rent schedules with additional deductions for income testing (Lithuania). Another way is to apply a certain rate to replacement cost, which may be different for municipal housing (1–1.5 percent in Poland) and for publicly sponsored non-profit housing (4 percent in Poland). Yet another way is the solely income-tested rent (Romania).

⁷¹ Private professional landlords have successively been replacing the administrative allocation decisions, held by tenants before restitution of rental buildings, with civil code contracts at negotiated rental rates.

As for the public sector buildings, public landlords throughout the studied countries generally are bound by specific and frequently changing governmental rent regulations. Where the public rental sector today is purely residual (Armenia, Lithuania, Serbia) rents are often not charged (but utility and maintenance costs are) or not collected. In other countries one finds a mixture of rent ceilings and rent increase caps (Poland), income-tested rent controls (Romania), and some movement toward using the cost-coverage principle (Russia). The lack of full cost recovery in those countries has led municipalities to cover shortfalls through cross-subsidization with incomes from commercial premises owned by them. A more drastic way to balance municipal budgets has been to let the housing stock partly decapitalize by deferring maintenance and capital repairs.

Rent Review

In the popular “micro market” dominated by domestic low- and middle-income tenants renting privatized apartments from individuals, rents are paid in local currency, although in longer-term contracts or upon renewal they may be indexed to a foreign currency (EUR or USD). In some cases these currency-based rents may be indexed to inflation.⁷²

Free unilateral rent review by the landlord upon roll-over or fixed-term contract renewal or extension is generally allowed for private rental contracts, unless they conflict with rent control provisions (Poland, Romania). Where regulations exist, reviews in permanent contracts can take place only semi-annually (Lithuania) or longer. Rents in fixed-term contracts usually can not be unilaterally reviewed, unless that option is explicitly stated in the contract (explicit ban in Russia).

There is *de facto* indexation of rents, but apart from the explicitly rent-controlled systems, formal protection of tenants against excessive rent increases upon contract renewal or extension (except in Poland) does not seem to exist. Actual landlord practice of using this degree of freedom varies with the market control they wield at a given time.⁷³

⁷² Indexation by real housing cost parameters (such as indexation to house price or construction cost indexes) is not common. Also, step-up rental agreements are hardly practiced.

⁷³ Interviews in Lithuania suggest that tenants are seldom aware of the option to close longer term contracts with fixed rents, rather than short-term rollover contracts.

Capital Repairs

Capital repairs are generally a duty of the landlord.⁷⁴ A tenant in Lithuania who is forced to undertake capital repairs has the civil code right to deduct the costs from his rent payment. Landlords in Lithuania and Romania who undertake capital repairs can demand temporary suspension of the lease and provide substitute housing. Rent review after capital repairs, however, is not generally regulated. It seems possible, given the currently liberal context of rent reviews for short-term contracts; however, the potential scale of capital repairs renders future court intervention quite likely.

⁷⁴ Civil codes of Lithuania, Poland, and Russia.

Table 11
Summary of Rental Laws in the Studied Countries

	Armenia	Lithuania	Poland	Romania	Russia	Serbia
<i>Governing law</i>						
Main legal reference	Civil Code	Civil Code	Civil Code	Civil Code	Civil Code, Housing Code	Civil Code
Specific rental section contained?	Yes (limited)	Yes	Yes	No	Yes	No
Secondary rent legislation exists (private/public)?	No/no	No/no	Yes/Yes	Only for restituted properties	No/yes	No/no
<i>Main issues</i>						
Lease terms used by private rental sector	Rollover	Rollover, Fixed-term, Permanent	Fixed-term, Permanent	Rollover, Fixed-term	Rollover, Fixed-term	Rollover
Rent setting in new contracts (private/public)?	Free/unclear	Free/cost-rent	Free/cost-rent (replacement costs)	Free/income-rent	Free/local ad hoc decision	Free/unclear
Public rent control option?	Unclear	Yes (not practiced)	No (disputed)	Unclear	Yes (not practiced)	Unclear
Rent review possible? ^a	Unclear	Permanent tenancies only	Permanent tenancies only	No	No	Unclear
Eviction ^b	Legally and in practice not possible	Possible	Possible; in practice, very difficult	Possible	Legally unclear; in practice, not possible	Unclear
Substitute housing required? ^b	Irrelevant	No; yes, in households with children	Legally no; in practice, yes (courts)	No	Legally no; in practice, yes	Unclear

Source: The authors' representation.

a. Within current contract term.

b. In case of nonpayment of rent.

Our assessment of the legal framework for renting is compiled in Table 11. The jurisdictions with the most advanced private rental sector, Poland and Lithuania, have the more complete legal frameworks, as well as Russia which recently reformed its Housing Code dealing mostly with social rental housing. Interestingly, the quality of the rent adjustment and eviction processes are less correlated to rental sector depth than what would be a priori expected.

Taxation

General Income Tax Treatment

The income tax treatment of rental housing is a crucial policy parameter that affects relative prices between rental and owner-occupied tenures and hence the profitability of investment and rent levels. As discussed in more depth in Annex 1, the commercial character of private rental housing activity has led most Western countries to pursue an investment concept of income taxation, which allows landlords to deduct costs from rental revenues before being taxed on them. This is generally not the case in the studied countries, with the exception of Poland (Figure 10). The current income taxation concepts applied to rental housing thus generally violate tenure neutrality and provide disincentives to modernize or invest in new rental construction.⁷⁵

Figure 10
Income Tax Treatment of Homeowners and Small Landlords in Selected Countries

		Tenure Neutral*		Consistent within Sector	
		Homeowners	Landlords	Homeowners	Landlords
Rent/imputed rent		T	T	NT	T
Costs of capital		T	T	NT	T
Lithuania					
		Homeowners	Landlords		
Rent/imputed rent		NT	T		
Costs of capital		T	NT		
Poland					
		Homeowners	Landlords		
Rent/imputed rent		NT	T		
Costs of capital		T	T		
Romania					
		Homeowners	Landlords		
Rent/imputed rent		NT	T		
Costs of capital		T	NT		
Russia					
		Homeowners	Landlords		
Rent/imputed rent		NT	T		
Costs of capital		T	NT		

Source: The authors' representation.

Notes: T = taxed/tax-deductible, NT = not taxed/tax-deductible.

*Good investment concept.

Figure 10 also compares the treatment of a private renter with that of a homeowner with mortgage debt. In all four countries, mortgage interest payments are tax-deductible - sometimes within limits - while the rental value of living in an owned unit (imputed rent) is not. This creates

⁷⁵ More country-specific information is included in the Annex 1.

an asymmetry of tax treatment both in the owner-occupied sector (because revenues are not taxed while costs are deductible) and between the mortgage and the rental sector (where revenues are taxed, but costs are not deductible—except in Poland). The result is, for a given investment amount, a relative increase of rents relative to the costs of owner-occupied housing.

When investing in new rental housing or major modernizations, initial net incomes for landlords are typically negative, because the sum of capital costs incurred for investments and operating costs exceeds rental revenues. As the investment seasons, the situation usually reverses and net income becomes positive. The tax system may help, or discourage, investors in such a situation. In the studied countries it is not possible to net negative income from letting against other sources of income or to carry negative income forward as a loss to reduce future taxable income. Poland allows carry forward of negative income, but not netting. Netting is a particularly important mechanism for small private landlords who have other sources of income against which to write off losses from renting but do not possess sufficient numbers of properties whose individual loss and profit situations cancel each other out.

Income Tax Incentives for Modernizing/Upgrading

Special incentives for modernizations for the rental sector in the studied countries are currently limited to Poland. While the housing market reform of 2001 abandoned the tax credit system for owner-occupiers, private rental investors were allowed to continue to use tax credits for modernization costs incurred in rental units. Up to 19 percent of the costs can be netted against the tax liability, up to certain cost ceilings per square meter. However, considering the effects of past rent controls and proposed caps on rent increases on deferred maintenance, the scale of the support is widely held to be insufficient.⁷⁶

Other Taxes

As in most Western jurisdictions, residential leases in the studied countries are exempt from value added tax (VAT). Exceptions are commercial and short-term residential leases that appear as commercial - such as hotel accommodation services (Lithuania applies a two-month limit, below which renting services are subject to VAT). Also, new construction and modernization (upgrading) of housing units is frequently value added tax-preferred (Poland, Lithuania) or exempt (Romania). A detailed review of this issue is beyond the scope of this study; however, examples in the owner-occupied sector suggest that capital gains and property sales taxation on rental units are very heterogeneous.

Tax Evasion and Enforcement

A major reason for tax evasion is inadequate enforcement on tax-informal subsistence micro letting, which is not pursued effectively in any of the studied countries, and small private landlords so far have been generally evading taxation. However, anecdotal evidence presented

⁷⁶ Access to soft modernization (upgrading) loans is provided by the government's development bank BGK, but it is reported to be difficult for private investors. These loans are related mostly to energy efficiency improvements on a larger scale, since energy audit and engineering design work is expensive for individual buildings.

above suggests that with the rising relevance of the sector tax authorities in Lithuania, Poland, Romania, and particularly Russia have started to tighten their controls.

Formulation of Tenure Policy

Historic Background

Industrialization and World War I

Private rental housing was the workhorse of the housing sector in the industrialization phase after 1850. By the turn of the XIXth and XXth Centuries, cities in Central and Eastern Europe had private rental shares in the order of 70 percent and larger (more than 90 percent in Budapest). Private land and building developers dominated the development market; large individual landlords provided standing investment finance for residential properties. The appearance of cities in the Region - contiguous city enlargements through new apartment blocks is inextricably linked to this private sector dominated development and finance process. It promoted a successful combination of high project density and scale fit to host workers for the industrial urban economy. However, the very success of the urban economy also attracted large numbers of rural migrants, resulting in overcrowding. As in other European countries, the war effort led to diversion of capital, reduced real incomes, and - given strong population growth rates - extreme housing scarcity. In only five years, between 1917 and 1922, almost all European countries introduced rent controls.

Interwar Period and World War II

In the inter-war period, the non-socialist economies safeguarded the property rights of private rental investors, but - in the light of revolutions in Russia and Germany that threatened to spill over to all Europe - lifted rent controls only gradually and selectively and started to promote member-owned cooperative and employer housing, as well as public rental housing projects in some isolated cases. Public rental received absolute priority in Western European housing policies in the first three decades after World War II, which were characterized by the most extreme housing shortage in history of many parts of Europe.

Socialist Soviet Legacy

The socialist Soviet experiment started in 1917 in Bolshevik Russia and consolidated its grip on the Region after 1945. The discrimination against private rental housing was a political hallmark of socialist ideology: private rental was considered a key mechanism of exploitation of the working class by capitalist landlords, and consequently became either legally prohibited (Russia, Lithuania, Armenia) or economically destroyed through expropriations, hard rent control, and unfair regulations (Poland, Romania, Serbia). Socialist Soviet housing policy was biased toward promoting tenure exclusively in public rental housing and non-member-owned housing cooperatives. The thrust was particularly strong after World War II, which left Central and Eastern Europe with destroyed cities and millions of refugees. Owner-occupied detached housing, in contrast, while economically disadvantaged with few exceptions (Poland, Hungary, Bulgaria), remained permitted and developed into the main tenure alternative to a public housing industry constrained by centrally planned resources. However, urban structure, infrastructure,

and construction resources remained tightly controlled, which put brakes on the owner-occupied sector.

Immediate Transition Phase

Immediate Transition Phase

The main argument behind the privatization drive that characterized the regional housing markets after 1989/91 (except in Poland) - was to render popular support for transition irreversible by creating nations of homeowners with vested interests in the reforms. The promotion of detached housing homeownership, particularly through mortgage market development, with less stringent condominium associations in the M-F stock, became the central policy lemma. It coincided with a retreat of social housing programs, a wave of privatizations of social housing stock, and a hardening political debate over the role of government in housing policy in the West.

Western political interests and constraints dominating external technical assistance played a key role in housing policy formulation in the transition countries. The financially best endowed and most focused sponsor of technical assistance in housing and local government affairs since 1989/91 has been USAID, whose housing policy agenda is strongly nested in a political environment that historically prioritizes homeownership. The European Union, which would have been a geographically and politically more natural partner with lesser constraints about tenure choice, has been forced to largely ignore transition country housing sectors because of its constraints in mandate.⁷⁷ To avoid a second source of large subsidies following the agricultural sector, the EU Treaty explicitly leaves housing policy to the ambit of the subsidiary.⁷⁸ Bilateral European assistance has been financially more limited and frequently suffered from a more blurred sectoral focus, compared with U.S. assistance.

The empirical outcome of this political focus was discussed in Chapter 3. It is now widely accepted that the thrust to promote individual ownership overlooked important economic aspects of the housing sector, particularly the structure of tenure and labor demand and issues of apartment stock management.^{79, 80} More disputed is whether these costs were justified in transition countries.⁸¹ Similarly, it is disputable to what extent actual capital value was transferred to sitting tenants with the units. In hindsight, an alternative interpretation seems equally plausible: central governments used the ideological umbrella to abandon what promised

⁷⁷ Housing issues and policy is left to member countries and thus is not subject of EU directives.

⁷⁸ Annual meetings of EU housing ministers are held for information exchange purposes. There is no Directorate-General directly responsible for the housing sector.

⁷⁹ See Maclennan (2001) on the outcome of the U.K. privatization experience for tenure choice.

⁸⁰ UN-Habitat (2003) makes a similar point in the context of tenure choice in developing countries. The report addresses several policy myths about the rental sector from the past decades.

⁸¹ For example, did the privatization strategy further its goal of creating political stability? Contrasting the Polish and the Russian experience with diametrically opposed privatization strategies would seem to speak against a positive answer.

to become an economic problem sector, leaving the solution to the new owners and local governments.⁸²

This unilateral focus on privatization resulted in some withdrawal and a substantial weakening of housing policy formulation capacities at the central government level. This gave room for the emergence of usually untargeted subsidies lobbied for by construction and finance interests. It led to a severe delay in enacting cross-sectoral policies needed to diversify investor structure and create tenure-neutral investment incentives. Similarly, the parallel processes of housing communalization and restitution received little attention and in the case of restitution ended in some disarray.⁸³ And finally, housing production plummeted during the first 10 years of transition to levels that threatened labor mobility and the overall economic outcome of transition.⁸⁴

Rethinking Housing Policy

Since the mid-1990s, several transition countries, especially in Central Europe, had launched a more diversified post-privatization housing policy debate and begun to formulate programs pursuing broader housing choice for diverse household categories, which included less tenure bias towards homeownership.⁸⁵ These had broadly the following elements:

- On the supply side, the legal framework was amended by laws enabling member-owned cooperatives and new public-private construction models (Poland).⁸⁶ Attempts to complete overall rent reforms remained unsuccessful, mainly owing to politics and populism at local government levels.⁸⁷
- Similarly, public funding mechanisms for modernizing / upgrading and construction of M-F buildings were provided through central government public housing or guarantee funds (Poland, Romania).⁸⁸ These partly also target private rental landlords.⁸⁹ Some cities

⁸² Little research supports the circulating figure of US\$1 trillion of wealth transfer (World Bank 2004a) because common property was not privatized and net asset values of privatized units were not based on future income/expenditures and expected building life. Anecdotal evidence of low and negative values abounds.

⁸³ Three major problems arose with restitution: use rights of sitting tenants were protected by rent controls (Romania, Poland); investment was impeded when a property was restituted to a mix of heterogeneous heirs; the court system and other public entities lacked capacity to manage the process. Dübel (1996) describes these interacting problems in eastern Germany.

⁸⁴ From the perspective of socioeconomic development, more new construction is needed to address the statistical deficit; the misfit between housing stock and households; the secular trend toward smaller households; the physical replacement imperative; the demand for higher product diversity; and factor mobility.

⁸⁵ See Dübel (2004) for a review of Central European housing policies.

⁸⁶ See Lux (2001). Also: Czech Republic and Slovakia.

⁸⁷ Rent policy competencies are typically held by local municipal councils, which are captive to highly populist rhetoric. These competencies include not only tenants' rents, but also owners' maintenance fees charged by municipal maintenance companies to privatized tenants.

⁸⁸ Also: Czech Republic, Slovakia, Slovenia, Croatia.

⁸⁹ For example, in the Czech Republic and Slovakia.

began assisting private landlords with necessary renovations, especially in historic properties.⁹⁰

- In the most direct form of intervention, public rental housing construction was revived at municipal level (Lithuania, Poland, Romania, Russia),⁹¹ with the support of central government funding mechanisms. However, production volumes have remained low and subsidy costs per beneficiary high.
- In Poland, the government recognized the need for more private rental housing and offered very generous subsidies to private investors who acquired new rental housing. The program was ended after a few years, when it was found that the subsidies were being capitalized partly by developers and partly by investors, who were looking for subsidized homeownership disguised as rental housing.⁹²
- On the demand side, attempts were made to strengthen purchasing power of low-income entrants through rent allowance programs (Poland, Russia). At the same time, weak or untargeted owner-occupied housing subsidies were cut back, as the mortgage market started to take off after 2002 after successful macroeconomic stabilization (Poland).⁹³ Most assistance schemes remain insufficiently funded and suffer from targeting problems, though.⁹⁴
- Consolidation of public housing policy budgets took place. Budgets eventually reached very low levels (in Central Europe), at levels of 0.3–0.9 percent of GDP, but this did not mean rationalization and did not expose numerous indirect and implicit subsidies not included in these figures. Large old subsidies and some new subsidies to the housing sector are channeled through ministries of finance (housing finance subsidies, tax support) or ministries of labor and social affairs (housing allowances, utility cost compensation, welfare), as well as in the form of implicit subsidies through local budgets (below- cost municipal rents and maintenance fees).

Reviewing Central European housing policy reforms Dübel (2004) concludes that even the most advanced countries execute housing policies with substantial inefficiency. Housing policy formulation and external policy evaluation capacity has not yet been firmly established, leading to erratic changes in policy focus and the absence of cost-benefit or tenure-impact analysis. Also, many new policies introduced in those countries were triggered by political pump-priming efforts arising from frustration with the recessionary impact of high inflation (Poland) or weak demand (Czech Republic). However, the fact that policy menus have become increasingly diversified, embracing larger private sector participation - and that budgets have been stabilized - must be seen as positive and meriting further policy dialogue and technical support.

⁹⁰ Such a program was introduced, for example, in Cracow, in the late 1990s.

⁹¹ Also: Czech Republic, Slovakia, Slovenia.

⁹² Developers were formulating special agreements wherein the dwellings were first rented on the market, but later occupied by their individual owners.

⁹³ Also: Czech Republic, Slovakia. Hungary transitionally expanded mortgage market subsidies but is currently reviewing its policy.

⁹⁴ Lux (2002) provides a recent comparative analysis of Central European housing allowance systems.

Present Tenure Policies

Status in the Studied Countries

By 2004 four of the six studied countries appeared determined to make further and more conscious progress toward less homeownership-biased housing tenure choice in their housing policy debates. Apart from the Polish case⁹⁵ these are Lithuania, Romania, and Russia. At this stage no consistent comparative program analysis for transition countries is available, especially with reference to budgets, cost-benefit analysis, and subsidy dependency analysis. Follow-up work is needed to expand the knowledge base in this area. Following are the strategies formulated by the studied country governments:

- Armenia adopted a housing policy framework in 1999 that prioritized improved housing management, housing stock modernization, and emergency provision of housing in the earthquake zone.⁹⁶ Changing rental housing legislation and developing a national housing allowance system are central to the agenda of the Ministry of Urban Development, mainly to increase cost recovery levels. Moreover, local governments are trying to consolidate their scattered apartment stock through various measures. The housing policy budget is unlikely to allow for an expansive rental sector strategy soon.
- With assistance of the World Bank, Lithuania formulated and adopted a comprehensive national housing strategy giving an important role to rental sector development.⁹⁷ The strategy report of 2002 and the final document of 2004 stress the importance of the sector for young and socially weak households and even formulate a target size for the formal rental sector of 18 percent of the housing stock by 2020 (up from about 10 percent in 2003). The proposed measures focus on developing private rental housing through conversions from the existing stock, through consolidation of the municipal social rental stock (and expansions, mainly through existing stock acquisitions, enabling non-profit housing initiatives through new legislation), and through funding a nationwide housing allowance program that also covers private rental stock. Whether the strategy can truly fulfill the expectation of a more tenure-neutral policy remains to be seen. The same strategy has already introduced mortgage interest deductibility,⁹⁸ which could distort the tenure choice of households with higher ability-to-pay for homeownership. Also, owners remain strongly subsidized through below-cost municipal maintenance and capital repairs done to multifamily buildings, as well as through subsidized mortgage insurance and up-front grants to first-time homebuyers. Such potential and actual distortions call for correction.

⁹⁵ Polish housing policy is analyzed in detail from the Central European perspective in Lux (2002) and Dübel (2004).

⁹⁶ See Dübel and Freinkman (1999) and UN-ECE (2004c).

⁹⁷ On January 21, 2004 the Government of Lithuania adopted Resolution No. 60 “On Approval of the Lithuanian Housing Strategy”. In Section 13 it stated that “... housing rental market does not exist”, and in Section 45 with strategy priorities it included “development of the rental housing sector”.

⁹⁸ Forced by the Ministry of Finance, which resisted calls for targeting and grading this implicit subsidy, claiming this was part of the plan to discourage young human capital from leaving the country.

- Poland has been pursuing the most pro-rental policy of the studied countries. This orientation has been consistent throughout transition, despite attempts to introduce mortgage market subsidies on a large scale and the long controversy about rent controls.⁹⁹ Although Poland today has a mortgage interest deductibility system, within limits, it should avoid the excesses of mortgage subsidization that occurred in the Czech Republic and Hungary. The social rental program has become diversified since 1997 through the non-profit TBS system, and some expect a breakthrough for the private rental sector from recent court rulings on rent control. Inconsistencies remain, however: a legal reform agenda remains, particularly for eviction; there is a fair amount of policy stop-and-go, particularly on budgets; and the housing policy program as a whole is still insufficiently targeted to the poorest households. (The housing allowance system is insufficient, TBS targets the middle class, there is no public housing for evicted tenants, public housing volumes are low, and there are rural infrastructure gaps.)
- In Romania a national housing strategy has been formulated and adopted by the responsible ministry.¹⁰⁰ The priorities are: enhancing homeownership through mortgage lending, completing unfinished buildings, modernizing (upgrading) the apartment stock, and constructing rental units for low-income and young households. The legal reform program is focused on mortgage and capital market development. However, a rent reform program is under consideration and may soon require more active domestic debate and policy dialogue with international partners. Because *ex post* evaluation of housing programs is undeveloped, the cost-benefit evaluation of the current investment and subsidy programs is not available. The proposed depth of subsidies in individual program formulations seems high (20 percent of the value of owner-occupied dwellings, 50 percent of the construction costs of social housing units), suggesting room for improvement in cost recovery and program reach.
- The President's Office in Russia has become increasingly active in supporting the development of the government's reform initiatives in housing and housing finance, although larger cities, especially Moscow and Saint Petersburg, have been also pursuing independent local housing strategies. The end of 2004 brought a flurry of legislative initiatives, most of which were adopted by the Parliament. They focused primarily on promoting individual homeownership by lowering transactions costs and providing greater access to mortgage finance and included tax benefits. In the rental sector, a new housing code has been adopted to replace the legislation introduced when resources existed for the provision of free housing. The code focuses on specifying social and commercial (private) tenancies, defining conditions for rent setting and eviction, and establishing criteria for tenants' eligibility for state aid. In this context, terminating the current privatization option after a transition phase of three years has been proposed. There are also intentions to introduce private rental and cooperative legislation. The budget implications of these tenure policies remain unclear and will likely be determined mainly at the local level. As tax impediments to mortgage finance are cleared, no similar

⁹⁹ At the inception of housing reforms, the intention was to begin with radical rent reforms, to introduce much higher housing effort ratios supported by requisite social protection schemes. These efforts failed because of substantial political resistance.

¹⁰⁰ See Ministry of Transport, Construction, and Tourism (2004).

initiative has appeared for the rental sector, where tax authorities have stepped up enforcement and discouraged landlords from formalizing their contracts. In social housing, similarly, resources do not match ambitions: the proposal to allow local governments to retain the full proceeds from urban land sales might lead to greater flexibility in funding local housing construction efforts.

- Serbia, with assistance from the World Bank and the Stability Pact for South Eastern Europe, has started formulating policy for a comprehensive national housing strategy. The strategy will likely focus on the full integration of refugees into the housing economy, land reform, and improvement in management of the existing housing stock, including condominium creation and public rent reform. Budgetary resources focus on reestablishing the government's ability to invest in housing sector infrastructure and funding urgent housing stock repair and maintenance. Both public and private investment in the sector is severely constrained by the low ability-to-pay of households.

5. STUDY CONCLUSIONS AND RECOMMENDATIONS

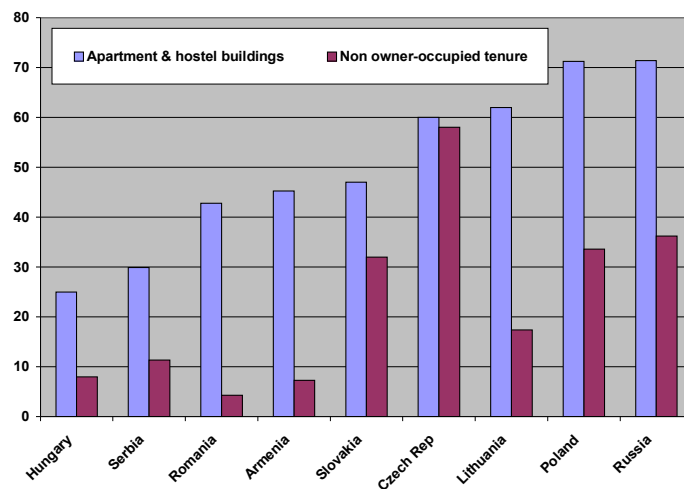
Conclusions

Regional Tenure Choice

Rental Housing Supply

Only a small supply of social rental housing “survived” the privatization waves of the 1990s. The rental sector in the Region as a whole, including private and non-profit rental housing, is much smaller relatively than in developed market economies with similar patterns of demographics, urbanization, mobility needs, and building inventory. This is especially so in Armenia, Serbia, and Romania, where the formal rental sector is a barely traceable residual. In Russia the rental sector is significant, but only because it consists primarily of social rental housing slated for eventual privatization. In Lithuania social rental is decimated, but there is a lively, informal rental market in individual apartments. In Poland the significant rental sector is more diversified and includes the restituted prewar rental buildings, and the cooperative rental apartment stock (Figure 11).

Figure 11
Building Structure and Rental Tenure in Selected Transition Countries



Source: World Bank LSMS study, Lithuanian Household Survey, national statistical offices.

Note: Czech Republic and Slovakia: all units in housing cooperatives counted as non-owner-occupied because of lack of detailed data on renting.

With the notable exception of Poland, the apartment sector in the studied countries is characterized by the lack of clear ownership titles to common property of M-F buildings and surrounding grounds. This can be described as a sort of shadow public rental sector despite the legal privatization of individual apartments. It indicates that the mass privatization policy produced high, unintended inefficiencies, by failing to produce homeowners willing and able to undertake necessary maintenance and capital repairs of common property in the M-F buildings that still dominate the post-Soviet urban areas.

Considering the conceptual and practical difficulties of implementing efficient common-property management systems in M-F building - difficulties not limited to the transition countries - the question arises whether the close correlations in mature market economies are not in fact a market rather than a policy outcome. The subsequent question is whether the observed deviations in transition countries can be called policy failures.

Rental Housing Demand and Rent Levels

The analysis of the household survey dataset suggests that tenure patterns in the Region follow broadly those observed in mature economies for age structure and incomes. However, the markets seem far too small to accommodate young and mobile households in quantitative terms. Conditions for young migrants in Romania and Russia seem most severe.¹⁰¹ This allows for the conclusion that low availability of urban rental housing reduces labor market adjustment at least in some transition countries.

As far as income is concerned, demand patterns in transition countries are skewed by the fact that young and mobile households, which show particularly high demand for rental tenure, are among the economic winners of transition. Hence the finding of both low- and high-income households in the private rental sector in some studied countries.

Standard predictions of filtering theories, which suggest low willingness of social stock tenants to move as incomes rise, are partly confirmed by the empirical findings. This result holds for both Poland and Russia; in the marginalized public rental systems of the remaining countries, higher-income households have privatized their units. Filtering in the remaining public sector stock in the Region is often promoted by the particular incentive structure imposed by “slumification,” which leads to an adjustment of building quality downward to rent levels.

There is evidence that the current swift expansion of the mortgage market reduces the natural growth prospects of the rental markets, as high-income tenants are pulled toward greenfield investment or higher-quality stock purchases. The effect varies with local financial and land and housing market conditions. It will likely put pressure on current rent levels and lead to faster filtering down of rental housing units. Given that the households with high ability-to-pay are leaving, minimum quality standards are moving to the fore of policy issues.

In the residual social rental sector, where prices do not adequately signal scarcity, typical target groups are no longer served. In all studied countries this affects the young and mobile, who have to rely overwhelmingly on the private rental sector or forms of homeownership to satisfy their

¹⁰¹ Although difficult to prove, anecdotal evidence suggests that the current considerable outmigration of young talent to the West is partly caused by the inability of these households to secure “decent” starter housing.

housing demand. Public hostel or rental programs for the young have been set up in several countries but seem rather insignificant. Furthermore, the “residualization” of the social rental sector is mirrored by the marginalization of its tenants in terms of income and age profile in all countries. The exceptions are Poland - which continues to have an active public housing policy - and Russia, with its large and yet undefined social rental stock.¹⁰²

Although only equilibrium values of tenure patterns and rent levels can be observed, the conclusion from the quantity-price relations observed in the studied countries is that rental housing demand in transition economies is rather strong. The housing expenditure and rent data suggest that, with the exception of Poland (which has residues of rent control), private rental housing costs are high relative both to values typically obtained in transition countries, and to public rental or owner-occupied housing expenditures. However, they are moderate compared with the rental burden in Western economies.

In terms of the efficiency of matching demand and supply through market mechanisms -including non-institutionalized and informal ones - the studied countries may be divided into three broad groups:

- The most advanced transition (and EU accession) countries (Lithuania and Poland) experience high demand pressure for renting, with supply being somewhat responsive, mitigating the upward pressure on rents.
- The mid-advanced transition countries (Romania and Russia) experience high demand pressure for rental apartments, which coincides with a pronounced scarcity of supply.
- The least advanced post-conflict countries (Armenia and Serbia) experience relatively subdued demand for housing in general, including rental housing.

These groups correspond to countries’ progress along the general reform path.

¹⁰² Since much of it is already slated for privatization, once the sitting tenants decide to execute their vested right to privatize.

Regional Tenure Policies

Legal, Regulatory, and Tax Reform

Progress in legal and regulatory reform of the rental housing sector in the Region has been painfully slow, with strong political resistance by numerous privatized tenant-owners and social housing tenants. These tenants dominate the political arena, given that they continue to enjoy high subsidies (explicit and implicit). Consequently, most regulations and subsidies deal with social housing, while private landlord-tenant relationships remain mainly unregulated.

It is perhaps over-stretched to cite eastern Germany's experience, where between 1990 and 1996 a complete set of rent and tax regulations was implemented and rents in the public stock rose fivefold to reach levels almost as high as those in western Germany (with socially weak tenants supported by housing allowances). However, the valid core factor may be that political resistance to legal and tax reform in eastern Germany was weak because the median voter was a West German single-family homeowner with little concern for the short-term interests of eastern German apartment tenants. The studied countries have a different political economy altogether, but this should not serve as an excuse for not tackling the remaining and necessary fundamental sector reforms.

It is difficult to distinguish the all-round best practice case among the studied countries. In terms of legal reforms, Lithuania's civil code is the most comprehensive effort; however, because default tenancy is permanent, it is potentially the most restrictive from the landlord perspective. The Russian legislation, especially the new housing code, can be expected to raise the current standard, if properly enforced. Tenancies are limited to five years, which helps circumventing a number of problems with regard to rent adjustment and termination. Poland recently made a bold move to liberalize rents in both the public and private sectors, while providing safety nets through an expanded housing allowance program. Legislation in Romania suffers from the restitution dilemma, to which legislation and the court system reacted very restrictively, especially through rent controls and eviction barriers. Comprehensive legal reform ending the lack of clarity over issues such as rent control and establishing standard terms is advisable. Armenia and Serbia both stand at the beginning of a legal reform program that also should encompass general civil code reform.

Rent control, or rent determination, deserves special attention. Progress in the private sector seems reasonable; however, conflicts are emerging for longer and permanent tenancies over the rate of rent increases upon reviews. Poland moved early in the right direction, linking rents to replacement cost levels and combining them with rent allowances, but has since suffered setbacks through court and parliamentary interventions. Rent determination in the public sector throughout the Region is still inconsistent with cost recovery principles, especially considering the large modernization needs. All legislation, most notably the highly restrictive Romanian legislation, maximizes the subsidies required per unit and household and therefore lead to a highly inefficient public rental housing system.

Beyond tenant-landlord and rent legislation, none of the studied countries has created an efficient dispute resolution and eviction execution system. Poland has the most experience in that regard, and the government's plan to support temporary municipal shelters in order to tear down the

eviction blockade is laudable. Still, the court system causes tight bottlenecks. None of the other countries has a dispute resolution system to speak of, apart from sporadic local solutions.¹⁰³

Significant tax reforms are needed to provide reasonable conditions for private rental investors. Only in Poland can landlords deduct costs from rent revenues before being taxed and have incentives for modernization been created. The gross rent tax systems of Lithuania, Romania, and Russia, in contrast, provide disincentives to rental investments. In Lithuania this problem is somewhat limited because of low tax rates and options for evasion. Developing the private rental sector requires a change in current tax policy designs for small and corporate landlords: the benefit will be diversified investor categories and higher activity, including new rental housing construction.

Social Housing Reforms

The new social rental programs that characterize four of the six studied countries suffer from deep subsidies and insufficient evaluation of costs and benefits, subsidy dependency, and targeting. Most public rental programs are too small and deeply subsidized to launch a significant attack on the problems they intend to address. The Polish TBS system seems to strike a compromise by successfully attracting private equity cofinancing and bank finance; however, a closer look will likely reveal deep subsidy dependency and an intended middle-class target group. A follow-up examination is recommended for this program, within a larger study of the need and form of PPP non-profit rental housing in ECA countries.

Given the low resources at hand, Polish, Romanian, and Russian local governments -independently from central governments - have adopted flexible approaches by buying new social units at the liquid secondary market. This strategy leads to lower housing standards for social tenants than under the socialist housing system, but it maximizes program reach and puts some downward pressure on private rents for the relevant target groups. Support for modernization investments and a tax system conducive to them could lead to similar efficiency gains, especially in the cooperative and private rental sector constituted mostly of old buildings. Programs that contain subsidies should be linked to targeting requirements, rent ceilings, and allocation rights for local governments.

Experience with housing allowances for poor tenants and owners - the favorite brainchild of the early transition years - has been mixed, especially due to often inappropriate administration, frequent program changes, and insufficient budget support. Better funded allowance programs could still fulfill useful purposes if they supported a faster adjustment of rents and housing costs to cost recovery level after investment. This has not been the case so far, leading to expensive dual subsidies (allowances and investment cost subsidies).

Future Research Needs

Empirical Research

Rental housing sector research has not been particularly strong in mature market economies outside the limited circle of countries with high rental sector shares and proactive rental policies

¹⁰³ For example, in Moscow.

(mainly Scandinavia, the Benelux, France, Britain, and Germany). Moreover, during the 1980s the rental sector was pushed ideologically onto the defensive and thus attracted less scholarly attention. Not surprisingly, the first wave of housing sector analysis for transition countries focused on homeownership and mortgage markets.

A second shortcoming lies in detailed monitoring of the housing market by governments and independent analysts. Most census specifications do not provide information about tenure forms and are hard for researchers to access. Surveys are rare, and microcensus analysis that would, for instance, track household moving chains is absent.

Improving the data support, which can sometimes be done simply by adding or reformulating questions in surveys or censuses, should be a first priority for governments interested in enhancing their rental sector policies. Follow-up studies are recommended with existing census and LSMS/HBS material, to differentiate the structure of demand and supply further. This could give valuable indications as to problem segments (such as high rent or housing cost ratios) that could be addressed by public policies (such as rent allowances), or the impact of certain policy measures (such as removal of rent controls).

In-depth country-by-country rental sector analysis is advisable for all studied countries. The minimum empirical program should include stock and flow modeling, as well as pricing analyses along the lines presented in this chapter, with more detail on specific hypotheses. If household survey data are insufficiently detailed or incomplete, additional surveys in selected urban areas should be conducted. Supply factors such as investor types, regulations, and tax treatment should be addressed, too (see Chapter 4). A survey design template for such studies appears in Annex 2.

The costs of such empirical efforts can be easily justified by the social and private benefits that policy action in favor of a broader and better functioning rental sector would bring. It is particularly advisable for countries experiencing significant private rental sector shortages (Russia and Romania in the study), or facing controversial policy choices, such as the transition from rent control to a market-based system (Poland). Worth further exploration are the interactions between the rental sector and labor market mobility, also in light of the developing spatial economics literature. A better calibration of labor market effects might help governments determine the right focus and scale of rental sector policies.

Tenure Policy Research

There are two relevant areas of future research in tenure policy: (i) detailed analysis of national rental housing policy frameworks; and (ii) cross-country policy studies deepening the understanding of actual practice.

Annex 2 contains a rental housing study template that combines elements of both empirical and policy analysis. In the policy section, it broadly follows the outline of this chapter. Such a template should be applied systematically in transition countries both to inform domestic policy debates and design, and to facilitate international comparison and exchange, including policy dialogue with the Bank.

There is also a need for better understanding of the impact and constraints faced by specific policy measures and comprehensive programs. For example, while there is relatively broad

evidence of the distortions caused by hard rent controls, there is little knowledge about best practices for engineering the adjustment from rent control to market mechanisms. Also, alternatives to hard rent ceilings - such as market transparency concepts underlying soft rent controls - better suited to investor-tenant compromise are under-researched. Analogies from the mortgage sector, where usury and adjustment regulations exist in numerous forms, could broaden the feasible policy menu. Similar arguments can be made about alternative taxation models and regulatory incentives or impediments.

Similarly important is the role of the public sector as a rental housing investor, a role that could play an important part in a poverty alleviation strategy, but which has come under “ideological siege” in the past 20 years. Partly as a result of political bias, research into new public investment strategies such as PPP and non-profit rental has subsided.

Specifically, in the transition countries, the question of reconstituting a social rental sector is both urgent and politically highly relevant, given the intensifying calls for action from policy makers. New policy strategies in this area should be supported by more in-depth analysis of the successes and failures of the massive privatization strategy of the 1990s.

Finally, inter- and intra-governmental institutional architecture issues should be studied to bring more understanding of the places where housing policy is explicitly or implicitly formulated and implemented.

Recommendations for ECA Housing Policy Realignment

Policy Directions

There is a strongly growing need to address the unintended consequences of the mass privatization policies of the 1990s. Countries should formulate explicit rental housing policies and implement requisite programs as part of the post-privatization realignment of their housing policies. Rental choice policies should be seen as vital complements to homeownership policies, not as residual and temporary measures. Countries should consider basing their rental housing policies on the principle of relying mainly on the efficient private formalized rental sector, supplemented by well-targeted social rental housing programs. Private resources can be mobilized into the rental sector through programs aimed at developing the private, PPP, and non-profit sectors.

The range of options for achieving these objectives include searching for ways to bring certain privatized apartments back into the social rental sector or under private landlord investors. For at least some of the apartment stock, where capital depreciation has not proceeded too far, a reversal of the early privatization policies could enhance efficiency. No historical precedent supports the view that a public rental sector can be both successfully and completely converted into an owner-occupied condominium sector.¹⁰⁴ Rental landlords, whether social or private, can be perceived as more capable - and thus more likely - to mobilize necessary resources for capital

¹⁰⁴ Maclennan (2001) tells the sobering story of the comparatively limited British experiment made by the Thatcher government in the 1980s. British right-to-buy units were proportionally more affected by the mortgage default crisis in the early 1990s.

repairs and upgrading, compared with the sometimes extreme socioeconomic mix of privatized tenant-owners unable to agree on necessary management and maintenance of common property in M-F buildings and surrounding grounds.

The national rental housing policy frameworks developed so far include some recognition that the reform of the urban apartment sector in transition countries is unfinished and that further progress cannot rely on individual apartment ownership alone.¹⁰⁵ Furthermore, their developers are more aware than ever that without real rent reform, including regulations of landlord-tenant relations, there will be no successful completion of housing reforms.

At least from a policy design perspective, the current policy frameworks of Lithuania, Poland, Russia, and Romania foresee a prominent role for the rental sector, although to varying degrees and with varying differentiation between public-private and formal-informal. Only Poland has given the private formal sector an explicit and consistent co-responsibility in rental sector development - as co-financers of non-profit rental housing and as owners in a large private rental housing sector. Also, except in Poland, alternative management and ownership structures for M-F apartment buildings other than condominiums (such as member-owned housing cooperatives or private institutional investors) play no significant role. Moreover, subsidized mortgage market programs and the decline in interest rates may “cannibalize” the rental sector by distracting high-income households to the greenfield single-family residential developments exacerbating urban sprawl’s negative externalities. The likely outcome of reliance on existing investor categories and current market trends will be a renewed thrust toward new public housing and costly public housing modernization programs.

Consequently, countries should consider anchoring their rental housing policies on the principle of relying mainly on the efficient private formalized rental sector, supplemented by social rental housing. Reliance on the private rental sector will require liberalizing rent determination; developing sufficiently clear landlord-tenant regulations, including dispute resolution and eviction procedures; securing sufficient competition to prevent usurious rent seeking; further developing nascent housing allowance systems; and establishing tax regulations that assure tenure-neutral treatment of investors.

Some countries are signaling the need to develop non-profit rental housing to address affordability problems of middle-income and lower-middle-income households, those too poor to afford homeownership and too rich to qualify for social housing or housing allowances. Only Poland has a government program in this area, but its outcome should be studied in depth for negative lessons and remedial recommendations.

Implementation - Insufficient Budgets

Whatever the formulated policy, public housing policy budgets in the Region are far too small to launch a serious attack on the problems of the apartment sector within any given policy design. Consider that current formal housing policy budgets in the Region are generally less than 1

¹⁰⁵ Skyner (2004) describes the legal, tax, and bureaucratic hurdles that the creation of condominiums face in Russia. The complexities of condominiums have historically led to their low empirical relevance in Western economies as well, where the sector covers less than 5 to 10 percent of the apartment stock. See Figure 1 and the discussion in Chapter 2.

percent of GDP, compared with the postwar spending of 5 percent of GDP and the current spending by Western European countries of 1–3 percent of GDP. These figures rise after recognizing indirect and implicit subsidies but are still below the practice in mature market economies.

Two significant causes can be identified: (i) continued push for fiscal austerity - partly caused by the desire for tax competition with mature economies and by related ambiguous international advice; and (ii) inefficient fragmentation of existing budgets, especially through parallel subsidization of housing programs and operation and modernization costs. This constellation will likely continue to preempt serious implementation success, except for isolated cases. Reducing fragmentation, especially by consolidating cost subsidies into the explicit housing budgets, should mobilize significant synergies.

There are two meaningful directions for enhanced public expenditures: (i) encourage larger private sector involvement in private or non-profit rental; and (ii) create a small, but sustainable, and hence manageable, social housing sector.

Implementation—Institutional Gaps

With the exception of Poland, and to a lesser degree Lithuania and Romania, the studied countries still have inappropriate housing policy institutions. Local governments are still too weak, both financially and institutionally, to manage housing policy. Properly managed and instructed finance agencies are needed to organize resource transfers from the central government, and the capital markets, to local governments and other investors in the rental sector. Private investor groups need stronger economic incentives to participate in the rental sector, and better political support.

Finally, housing policy needs regular monitoring, evaluation, and review. The current political structures are often not conducive of independent reviews that question the efficiency and success (goal attainment) of policies, although such structures do exist and are indirectly influential (Poland, Russia). In general too little budget is reserved for communication with the public, data generation and management, and analytical and comparative work. This deficit raises the risk of costly misallocation of scarce public resources.

ANNEX 1

KNOWLEDGE BASE ON HOUSING TENURE CHOICE

Housing policy programs in the ECA transition countries have often been designed by line ministries in response to political expediencies and special interest lobbying pressures. The general lack of comprehensive housing strategies can be ascribed partly to the lack of a sector wide knowledge base available to the fledgling policy expert communities. Consequently, this annex starts compiling the knowledge base requested by these experts as a measure of domestic capacity building.

A) Theoretical Analyses

Housing Market Theory

Over the past forty years, the topic of housing markets has generated a significant body of literature. Numerous studies have focused on issues related to housing demand, housing tenure, and housing market behavior. Building on the lines of thought of neoclassical theory, ample empirical evidence suggests that housing as an economic good responds to market forces in a manner similar to that of other commodities. Yet, housing does not deliver only one good as it features a wide array of characteristics, including durability, spatial fixity, and heterogeneity. Moreover, there is extensive involvement of government with the argument of housing as a basic need for all households. Therefore, there are reasons to argue that it is impossible to analyze housing decisions within the framework of the neoclassical theory of supply and demand without modification.

The Standard Model

The standard neoclassical model of housing demand advances several theoretical arguments about consumer behavior, the nature of the housing commodity, and the housing market. It looks on housing consumption decision making as a part of broader utility-maximizing consumer decision making (see below). In doing so, the heterogeneity issue is disregarded by assuming the existence of demand for an unobservable homogenous commodity called housing services (Muth 1960; Olsen 1969). However, the standard model already examines the durability character of housing by treating housing as a homogeneous capital stock that yields one unit of housing services per unit of time as quasi-dividends. Other assumptions include perfect capital markets, a tax-free environment, and asset markets in equilibrium (Deaton and Muellbauer 1980).

The neoclassical theory postulates that households maximize their utility with respect to different goods and services, including housing services, subject to a budget constraint where expenditures for housing are part of the total expenditures. In this setting the general form of the housing demand equation can be expressed in the following form:

$Q = q(Y, P_h, P_o, T)$, where Q is housing consumption, Y is household income, P_h is the relative price of housing, P_o is a vector of prices of other goods and services, and T is a vector of taste factors.

The Standard Model can answer general questions regarding the relationship between income and price for housing services or building materials and housing output as well as the impact of preferences on housing demand.

The Inter-temporal Dimension

The *first departure* from the standard model adds the inter-temporal dimension, i.e., the empirical fact that short-term housing consumption (demand) depends on long-term housing investment decisions. The linkage is provoked by the imbalance between typically large initial investment costs ('lumpiness') vs. the low initial depreciation rates and other consumption utility flows derived from the housing stock. The result is a mismatch of the excess of utility over costs in the flow perspective – initially negative, then turning positive - that requires some sort of inter-temporal financing. And vice versa, because of these stock-flow characteristics housing is popular as a storage of wealth and a long-term asset in the retirement portfolio of households.

The analysis of housing decisions with an inter-temporal modeling framework was historically developed jointly with the literature on life-cycle decision making (Blinder 1974, Beach et al. 1981). In the typical setting households maximize their lifetime utility subject to multi-period budget constraints. The formulation of lifetime budget constraints requires further specification of assumptions about the flows of incomes, prices, interest rates, depreciation rates, and the conditions of financial markets. The main impact of the inter-temporal modeling framework on the Standard Model has been to introduce different housing supply curves – short and long-term – whose relative slopes depend on the above assumptions and which are linked through an investment function.

Capturing Heterogeneity

The *second departure* of the Standard Model considers the heterogeneity of housing in terms of delivering goods to households. Two approaches can be distinguished. The *first approach* suggests that households value only individual goods derived from housing for their individual characteristics (Becker 1965; Lancaster 1966). The *second approach* is based on the assumption that housing is a bundled commodity possessing both a quantity and a quality dimension. The so-called characteristics framework introduced by Rosen (1974) combines both approaches and has been widely applied in housing research. It allowed analysts to study a housing unit as a vector of tangible characteristics. The pricing of the housing unit depends on the presence or absence of these characteristics. As Smith et al. (1988, p. 37) point out, "Various bundles and their associated prices reveal the implicit prices of characteristics, known as hedonic prices." The main advantage of this approach is that empirically hedonic prices can be determined which may be used to estimate demand functions for individual housing characteristics (Quigley 1979). Over the past decades, the characteristics framework has arguably produced more realistic hypotheses than those obtained by relying on the Standard Model featuring only one homogeneous good.

Spatial Fixity

The most recent strand of housing market theory that has only fully developed in the past two decades generates a more refined view of the spatial fixity of housing, and thus important departures from neoclassical theory. Fujita, Krugman and Venables (1999) present this

dynamically developing body of research in the general context of spatial economics. The general line is to see location as the single economically dominating element of the characteristics set of housing and as a consequence of the singularity of location to regard the perfect competition assumption between housing units being in different locations as unrealistic. Rather, in the mainstream of the new literature the production function for goods or services derived from housing units is typically characterized by increasing returns of scale at the regional (inter-agglomeration) level and monopolistic competition at the urban (intra-agglomeration) level. Analysis of transport costs, which has been the nucleus of this type of research developed already in the 19th century, and other spatial factors add to the understanding of the competition structures within the urban housing stock and between urban and suburban housing stock.

Tenure Choice Theory

The strand of housing theory literature of specific interest for the present study explores the determinants of household housing tenure choice and the optimal share of renting vs. owning in society as a whole.

Again, the starting point is the neoclassical theory that assumes the rationality of economic agents and their ability to choose different types of tenure in order to maximize utility subject to a budget constraint (Arnott 1987). However, with homeownership both consumption and investment decision now fall together and need to be taken simultaneously by the same household. Obviously not all households are able or willing to do so. Building on the observation of household heterogeneity, both economic and socioeconomic approaches have been developed to account for differences in tenure choice.

In the economic approach, household income and wealth as well as exogenous factors such as taxes and relative prices are considered as the main determinants of the tenure decision (Henderson and Ioannides 1989; Plaut 1987). There is a broad consensus among researchers that the propensity to become a homeowner increases with household income and wealth. The economic approach also postulates that changes in relative prices such as mortgage rates, tax levels and inflation rate influence tenure choice. Relative prices can be captured in user costs of capital approach summarizing the costs of homeownership and the costs of renting. In addition, transactions costs of becoming a homeowner (e.g., stamp duties, notary costs) and access to finance play a significant role – but these factors have mostly emerged from empirical research (see below).

In contrast, the socioeconomic approach argues that tenure choice involves a deeper interplay of socioeconomic characteristics of households and supply-demand conditions in the housing market (Clark and Dieleman 1996). For example Deurloo et al. (1987) claim that tenure choice is affected by demographic factors through changing socioeconomic status rather than through the life cycle alone. Age, family size, and family composition are significant factors affecting tenure choice (Deurloo et al. 1987) and households are likely to change their tenure choice toward homeownership when they become older or start a family.

The subsequent section discusses selected empirical research that has been undertaken with regard to the discussed theories.

B) Empirical Analyses

Arguably, the empirical work on the determinants of housing demand and tenure choice has at times been more advanced than the theoretical one, due to the prevalence of political and practical over academic interest in the sector. In developed markets, many policy institutions, such as financing agencies or housing ministries, sponsor regularly empirical housing research.

According to Rothenberg et al. (1991), empirical housing research can be grouped into four categories: demand for housing services, demand for individual housing attributes, neighborhood choice analysis, and tenure choice studies.

Demand for Housing Services

The bulk of empirical research has been undertaken in order to estimate the effects of income and price elasticities on demand for housing services. In these studies, housing services are typically modeled as a continuum quantity and considered as a function of the price of housing, non-housing expenditures, and other socioeconomic variables.

Being held as the first author to have estimated the income elasticity of housing demand, Houthakker (1951) set the agenda for subsequent analyses in the field. However, despite numerous empirical studies, the magnitude of income elasticity of housing is still widely debated in academic literature.

One camp of economists contends that housing demand is generally very elastic with regard to income (DeLeeuw and Ekanem 1971). According to Arcelus and Meltzer's (1973) estimations, the income elasticity of housing demand for the U.S. is 0.94. Arcelus and Meltzer suggested that the demand for housing services depends on the real value of financial assets. Using Lorenz concentration curves, a more recent study by Hansen et al. (1996) demonstrated that income elasticity is somewhat less than unity for all income levels.

Challenging the results of high income elasticity, other studies have estimated the income elasticity of housing demand as low as 0.1 (Kain and Quigley 1975). Mayo (1981) also concluded that the demand for housing is rather income-inelastic, with parameter values ranging from 0.25 to 0.70 for renters and from 0.36 to 0.87 for owners. The findings from Goodman and Kawai's (1984) study lent further support to Mayo's.

Several studies extended this research by exploring the correlation between income and the income elasticity of housing demand. Ihlanfeldt (1982), for example, showed that the income elasticity of housing demand tends to rise with the income level. He found that the income elasticity for low-income households falls between 0.14 and 0.62, whereas in the case of high-income households it lies between 0.72 and 1.1. Using time-series data, a study undertaken by Mayo and Sheppard (1996) estimated that the income elasticity ranges from 0.5 to unity across income levels. Most studies found support for the argument that the income elasticity of owners is moderately higher than the one of renters. Only a few empirical investigations have produced evidence that income elasticities exceed unity.

Demand for Individual Housing Attributes and Neighborhood Choice

Another body of literature puts the demand for individual housing characteristics at the center of its analysis. Such characteristics as location, number of bedrooms, and number of floors have been analyzed. In this line of research, authors have looked into the provision of public goods as an additional factor affecting housing demand.

Building on McFadden's (1978) seminal paper, a strand of the empirical literature focuses on neighborhood choice. Ioannides and Zabel (2003) showed empirically that individuals prefer to have neighbors with similar socio-economic characteristics. They estimated that the elasticity of housing demand with respect to the mean of the neighbor's housing demands ranges from 0.19 to as high as 0.65.

Tenure Choice

The determinants of tenure choice have been widely empirically researched in a number of directions.

Permanent income, relative prices, taxation.

Early studies on housing tenure choice have focused on the role of permanent income and relative prices, as measured by the user cost of capital in rental and owner-occupied housing, as determinants of tenure choice (Rosen and Rosen 1980; King 1980).

More recent research added or deepened the analysis of the impact of taxation to the user costs, especially in the U.S. where mortgage interest deductibility has a long tradition (Titman 1982; Narwold 1992; Wood 2001).

Access to finance

A core aspect of tenure choice that has been widely researched are barriers to access to homeownership imposed by financing constraints such as down-payment requirements. The available studies confirm the expected negative impact of such constraints on homeownership. (Jones 1989, 1995; Linneman and Wachter 1989; Haurin, Hendershott, and Wachter 1997; Rosenthal 2002). The question of tenure choice and access-to-finance constraints of immigrants has been addressed in more recent studies (Coulson 1999).

Employment status and income uncertainty

Frogner (2002) investigated the effect of employment status on housing choice using U.K. data. She found that the employed are more likely to become homeowners than the unemployed. The study also found an independent impact of the number of breadwinners in a household on tenure choice. Approximately 70 percent of homeowners in the U.K. belong to a household in which at least one adult works. The share of homeowners reaches 84 percent if the household has two or more working adults. Frogner attributed the regional differences in homeownership rates observed in the U.K. to relative strength of labor markets. In her sample, higher homeownership rates are correlated with lower unemployment rates.

Diaz-Serrano (2004) investigates the effect of labor income uncertainty on the probability of homeownership in Germany and Spain, two countries with highly different rental housing shares. He observes for both cases, though, that households facing increasing income uncertainty display

preference for renting, while those with lesser uncertainty show a greater propensity for homeownership.

Age and income co-linearity

Econometric analysis of tenure choice often suffers from co-linearity between age and income variables. Controlling for income in a European cross-country review with European household panel data, Barcelo (2003) finds empirical support for the life-cycle theory of tenure choice: younger individuals show a higher probability of living in rented houses. An important aspect of the life-cycle theory is access to finance, and here in particular the requirement of large down payments hinders home acquisition by young households.

Interest rates

Painter and Redfearn (2002) explore the role of interest rates in explaining homeownership and housing starts. The authors present evidence that in the short run, changes in interest rates or incomes have no effect on homeownership rates. In addition, even rather large swings in interest rates have insignificant long-run effects on homeownership rates, while changes in incomes and demographic variables cause considerable variations in homeownership rates over time.

Rent controls

Rent control is a strong candidate for impacting tenure choice because it directly affects the relative user costs of owning vs. renting. Rent controls are also held to interrupt the filtering up of higher-income households, which without benefiting from such protections would vacate lower-quality units for lower income households more quickly. Somewhat surprisingly, the empirical literature does not cover the impact of rent control on tenure choice and filtering in great depth. In an otherwise comprehensive overview paper Arnott (1998) makes some cursory reference. He points to some level of ambiguity as far as total homeownership demand is concerned as rent control may either decrease (for sitting tenants) or increase (for outsiders) demand. At the same time, he argues that controls unambiguously provide a clear incentive to convert rental units into condominiums, a move often met with legal restrictions.

Transactions costs

Tenure choice is also clearly affected by transaction costs for the acquisition of housing. In Europe and the United States typical acquisition costs for houses or apartments are between 5 and 10 percent of the price and thus considerably above transaction cost levels for rental units. Harvard's Joint Center for Housing Studies (2004) finds in that regard that two-thirds of U.S. owners who move choose to become renters initially, most likely because of transaction costs. This is consistent with older findings of Weinberg, Friedman and Mayo (1981), in which with U.S. household survey data they showed an disproportional increase in the likelihood of moving of renters in response to the desired change in housing consumption, hinting at the relevance of transaction costs.

Cultural Factors

The changing make-up of the American society has stimulated scholarly interest in the analysis of the relationship between race, immigration and tenure choice. By examining the tenure choices of African-Americans, Hispanics, Asians, and whites, Coulson (1999) found evidence for the effects of income, market prices, demographics, and immigration status on differentials of homeownership rates. He documented however that difference in incomes dominated in

explaining the black-white and Hispanic-white differences in homeownership. Coulson further found that immigrants had substantially lower rates of homeownership. In addition, Painter et al. (2001) shows that the differences in homeownership rates among Asian, Latino, and white households can be explained by income differentials, immigrant status, and household mobility. However, these factors in his findings fail to explain large parts of the differences in homeownership rates between African-American and white households.

Multifactor Studies

The empirical analysis conducted by Gyourko and Linneman (1997) exemplifies empirical studies that examine a combination of demographic and economic factors in relation to tenure choice over time. Gyourko and Linneman argue that the speed of convergence in homeownership rates between the most educated and least educated households has significantly decelerated in recent decades in the United States. Furthermore, their empirical estimation results demonstrated that such traditional demographic factors of ownership rates as marital status and the presence of young children in the home no longer exercise a strong effect on tenure choice, whereas the predictive power of education and income (wealth) has increased in accounting for homeownership patterns. Finally, the study documented evidence that homeownership rates substantially increased among the youngest adult households during the 1980s and 1990s.

Cross-Country Studies

Since homeownership rates greatly vary from country to country, several recent studies tackled the issue of housing tenure choice with cross-country comparisons. Using data on 14 OECD countries, Chiuri and Jappelli (2000) demonstrated that financing constraints, such as the level of down payment required for obtaining housing finance, are an important determinant of homeownership, particularly for the young. The estimated coefficients indicated that increasing the down-payment ratio by 10 percentage points reduces homeownership by 1.6 points. They also found that demographic variables, both household size and education, are positively correlated with homeownership rates. Based on their estimation results, Chiuri and Jappelli concluded that convergence in European mortgage markets will increase demand for housing and mortgages.

Linkages between Tenure Choice and Labor Mobility

An important strand of the tenure choice literature studies the implications of tenure choice for the labor market. The recent study by Barcelo (2003) quoted before also empirically examined the relationship between housing tenure choice and labor mobility in five European countries using the European Community Household Panel Survey. Barcelo finds homeowners to be more reluctant than renters to move to other areas to work. Another important finding is that owners and renters living in social housing respond to changes in the local labor market in a fashion similar to private renters. They differ, however, in their desires to migrate for job reasons from private renters. The study also suggests that the probability of changing residence for job reasons is higher if the homeowner has a larger outstanding mortgage.

In analogy to the transaction costs argument for homeowners, Svarer, Rosholm, and Munch (2003) show with Danish data that households living in rent-controlled units are less likely to accept jobs outside their local labor market and are unemployed longer.

C) Tenure Choice Policy Best Practice

Intervention Rationales

The Identification Problem—Market or Policy Failure?

Rental housing policy interventions have historically been motivated through the persistence of extreme market signals, such as extremely high rents, high levels of crowding or vacancies, supply shortages, and resulting labor market imbalances. In economies where renters have strong political clout, such spells have resulted in high levels of policy intervention, with significant resources or regulatory verve. One-time policy interventions—such as the introduction of rent controls in Europe at the end of World War I—frequently became permanent features of the housing market. The fundamental questions to be addressed when designing a policy program are therefore whether extreme market signals are due to failure of markets or of policies, and what the cost-benefit relation of policies is.

Types of Market Failure

Various types of market failures can be responsible for the presence of high prices in the rental sector. We discuss two key types of failure: imperfect market structure and information asymmetry.

- The rental market has been a textbook case for less than perfect market structure, producing monopolies or monopolistic competition situations with resulting pricing powers on the side of landlords.
 - The slumlord is a typical example for monopolistic competition: in a market economy, every tenant in the slum has the option to move into a better neighborhood; however, this usually requires a large stepwise increase in affordability. Until this affordability level is reached, the slumlord can exploit the situation by charging excess rents or allowing housing service quality to deteriorate.
 - Public housing policies address the problem by introducing minimum housing standards and regulating rents, or producing public rental units. However, ill-designed policies may not cure and may even exacerbate market failure. The pricing power of landlords is more limited, the faster new rental units are supplied (through new construction or conversions of owner-occupied units). This speed is often slowed by minimum housing standards, which increase landlords' pricing powers in the remaining - now informal - markets.
- Landlords need remedies to overcome information asymmetry with respect to the tenant's ability and willingness to pay, or inclination to maintain the apartment. Rents may become very high if such asymmetries persist; for example, because deposits are outlawed or eviction is costly or impossible. Similar asymmetry may exist on the side of the tenant, with respect to necessary repairs or maintenance. Public policies have addressed asymmetry issue through laws governing tenant-landlord relationships. The danger is that laws that protect tenants discourage rental housing supply too much and lead to an adverse selection of landlords, promoting slumlords.

- Similar asymmetries and selection effects may arise on the funding side, because landlords require capital market funding with loanable funds for investment. Systems with under-funded rental landlords tend to be characterized by neglect and deferred maintenance. Funding rental landlords is risky business for lenders, though. Inadequate leverage and mismatch may lead to an increase in bankruptcy risk - landlords may hold variable-rate assets and be funded at fixed rates or vice versa. Ill-defined small business bankruptcy laws may make finance extremely costly. Some landlords may not have any access to finance. Public policies have responded to these problems by creating larger borrower entities, such as public housing companies or cooperatives, or facilitating landlord access to finance through public loan or guarantee programs.

Types of Policy Failure

Even a superficial look at the history of European and American housing policy in the twentieth century would suggest a high incidence of policy failure - that is, policies that caused rather than cured rental market shortages.

Particularly relevant are interventions that permanently altered the relative price relations and therefore massively intervened into investment and tenure decisions of the private sector. Several relative price relations are of interest: those between the main submarkets of the housing sector, which interact through the filtering chain, and those between the housing market and capital and labor markets.

Tenure Neutrality and the Filtering Chain

Apart from policy failures related to microeconomic problems discussed above, the most drastic housing policy failures have related to violation of the neutrality of household tenure decisions and the consequences for filtering process.

Considering building technology as given, the relation between rents and mortgage rates is the central relative price of the housing sector. Rents subsume various factors of the housing market in one price: size, location, and quality. They also contain policy factors such as taxation and subsidies provided to landlords. Similarly, mortgage rates provide market information about the opportunity costs of resources spent for land acquisition and construction, risks on the capital market or individual credit risk, and policy factors such as public guarantees, taxes, and subsidies.

The relation between both prices determines tenure choice and thus the relative size of rental and owner-occupied housing markets. Hence, policy distortions in any of the two prices may lead to distortions of tenure choice and relative market size.

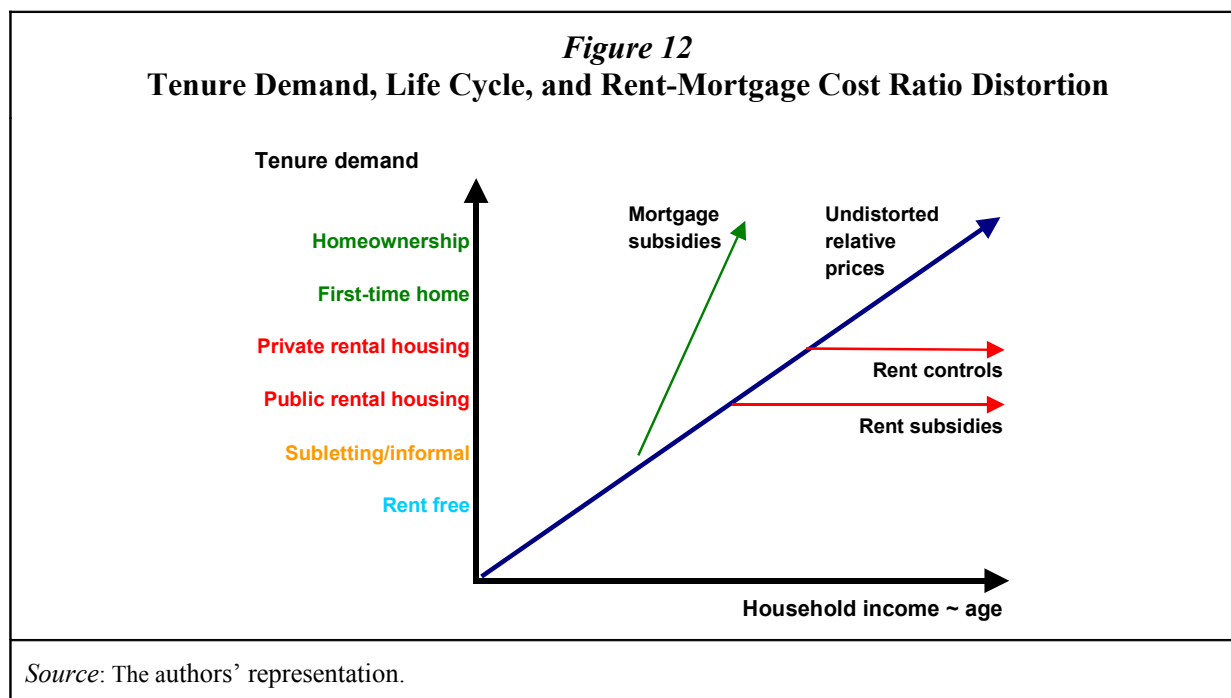
The pattern of migration of households through the housing stock over time is shown in Figure 12. As household incomes rise, the income effect allows higher housing consumption, which typically requires changing the tenure form. This characterization is stylized, because the quality distributions of rental and owner-occupied units in reality overlap.

Rent-free and subletting arrangements mark the start of a housing career, typically followed by some form of social housing (employee or student housing), then - with a job change or the first job after graduation - a private rental apartment, the first home with the start of a family, and finally perhaps a larger home. Each time the household vacates a unit, a better-quality unit is

demanded - perhaps even a new one. Thus lower-quality (often older) units filter down the income scale.

Interventions into the relative prices of rent and mortgage rates cause problems for the filtering chain (Figure 12). Price interventions carry the risk of leading to excessive length of tenure in a specific stage of the housing career. This in turn leads to underuse of a given household's ability and willingness to pay for improved housing:

- Rental subsidies or rent controls may wean sitting tenants from the low costs of renting. As household income rises and the subsidy or control mechanism becomes mistargeted, the tenant will sit too long in rental tenure, lowering in turn the aggregate demand for owner-occupied housing. As a unit remains too long occupied and new rental supply is discouraged, households at lower income levels are confined to subletting or informal renting. If subsidies or price controls prevail, the only mechanism that gets the filtering chain back to work is to adjust the quality level to the rent level, by neglecting repair and maintenance.
 - Rent subsidies have been typical in many European countries, particularly France, the Netherlands, Nordic countries, and Germany. All these markets have low owner-occupied housing sectors and low mobility of tenants and spend large proportions of their GDP on housing subsidies.



- Rent controls without supporting subsidies and with consequent deteriorating quality were characteristic of the British and Spanish private rental housing

sectors until the 1970s and 1980s. In both markets, the share of the rental sector declined drastically over several decades.¹⁰⁶

- Deteriorating quality levels are also typical for many countries that have extreme public rental housing sector shares, particularly transition countries. The political economy of public rental often works against rents keeping pace with repair and maintenance costs.
- Mortgage subsidies work toward the other extreme. They shorten rental sector tenure extremely and expand homeownership tenure beyond the economically sustainable period. Filtering down of lower quality units to rental is impaired and many rental units are converted and upgraded to owner-occupied status. The housing market becomes deeply segmented.
 - The most extreme example is perhaps the United States, where a combination of de facto unlimited tax deductibility of mortgage interest payments and public and private guarantee systems leads to extreme relative price distortions compared with renting.¹⁰⁷ When the current mortgage market setup was created in the 1930s, rental housing was even excluded from loan guarantee schemes, a fact that has contributed to the urban decline that reached its culmination in the riots and high criminality levels of the 1960s and 1970s.
 - The most damaging policies have been characterized by combinations of mortgage market subsidies and rent controls. Examples are the British housing market in the 1980s or the New York housing market. These situations usually lead to extreme levels of conversions and loss of rental housing stock.

A rational policy will come close to an economic first-best situation, in which relative price relations between the relevant markets are not generally altered.¹⁰⁸ It will carefully analyze effective prices and (user) costs of capital, adjusted by taxes and subsidies, before making decisions.¹⁰⁹

Intervention Instruments

We focus here on interventions enabling or disabling the private rental sector.

Regulation/Deregulation of Rents and Tenure

Rationale

Rent and tenure regulations may structure the tenant-landlord relationship in a way that minimizes the negative implications of information asymmetry. It may further address material protection issues, such as those arising from asymmetries of bargaining powers between landlord

¹⁰⁶ See European Central Bank (2003).

¹⁰⁷ See Joint Center for Housing Studies (2004).

¹⁰⁸ This argument was used in housing policy debates of the 1990s to promote lump-sum demand-side subsidies, which fulfill theoretical conditions of decision neutrality. We will return to this point in the instrument discussion.

¹⁰⁹ A good example of adherence to this principle was the German housing policy commission of 1995, headed by Hans-Werner Sinn. See Expertenkommission Wohnungspolitik (1995).

and tenant, from transactions costs (such as costs of moving) or imperfect market structure (such as monopolistic competition). However, ill-defined regulations historically created extreme policy lags and proved disastrous for the rental housing sector.

Evidence

Arnott (1998) provides a comprehensive literature overview focused on the impact of rent control. In historical perspective, rent controls can be differentiated between first and second generation. First generation controls, often the result of temporary policies during spells of high inflation or wartime housing shortages, aim at freezing rents and controlling their adjustment. Second generation rent controls introduce regulation governing conversion, maintenance, and tenant-landlord relations. Rent controls are found to lead to excess housing consumption by tenants, a recessive effect on the provision of rental housing and conversions into other uses, and wealth distribution effects between tenants and landlords. Concerning excess consumption, one of the earlier empirical studies by Olsen (1972) estimated that occupants of rent-controlled dwellings consumed 4.4 percent fewer housing services and 9.9 percent more non-housing goods than they would have consumed in the absence of rent controls. Early (2000) estimates the net benefits of rent control to tenants in New York City. His study concluded that, on average, tenants in rent-regulated units would have been better off if the regulations had never been introduced. Rent control acts all over the world, including India¹¹⁰ and South Africa,¹¹¹ have been found to have similar effects.

Dübel and Pfeiffer (1994) analyzed the situation in 11 European countries during the hot phase of rent deregulation. By the mid-1990s, a major re-thinking had taken place that had led to radical liberalization of rent legislation in those European countries whose private rental markets had suffered from controls dating back to World War I: Spain, Portugal, Britain, the Netherlands, and Denmark. New rental contracts became completely liberalized. Rent freezes or strict level controls were mostly abolished and replaced by cost rent (public sector) or comparative rent (private sector) systems.¹¹² To cushion the adjustment costs for tenants, rent increases for existing contracts arising from liberalization were capped or supported by rent allowances.¹¹³ Most countries also introduced some form of rollover of modernization costs on tenants. In addition, a certain convergence of tenure regulations took place. Britain started departing from the traditional Anglo-Saxon roll-over rental contract¹¹⁴ and with the 1988 Housing Act introduced permanent (“assured”) tenancies. Germany, in turn, which had known only permanent tenancies, during a rental housing crisis in the late 1980s introduced short-term tenancies.

Rent deregulation has widely been found to promote private rental sector development. In the United Kingdom, the sector expanded after the 1988 reform. Bailey, Findlay, and Gibb (1998)

¹¹⁰ See Rama Rao (2000).

¹¹¹ See Dübel and Pfeiffer (1996).

¹¹² The approaches to comparative rent systems differ: The British Housing Act of 1988 referred to reasonable rent levels and created a mediation system to enforce them. The German legislation moved toward inducing local governments to publish rental data raised with annual rent surveys (*Mietspiegel*), facilitating formal litigation.

¹¹³ In some countries with newly reformed rent legislation (as in Spain) the highly regulated old rental contracts—often oriented on old housing stock—are still in force, resulting in a divided market.

¹¹⁴ The standard U.S. contract for example has a one-year duration and is symmetrically callable by both landlord and tenant.

find that private rent changes were modest. Similarly, the Finnish rental housing sector experienced a rebound after the 1994 reforms. However, the speed of decontrol varied, depending on the degree of protection of sitting tenants:

- In Italy, seven years after the 1992 rent reform, only an estimated 24 percent of tenancies were under the new law. Similar problems were recorded for Spain and Portugal (European Central Bank 2003).
- In England, seven years after the 1988 deregulation, only 12 percent of private tenancies were not under the new law (Bailey, Findlay, and Gibb 1998).

The European Central Bank in 2003 devoted large parts of its report on “Structural Factors in the EU Housing Markets” to the rental sector. For rent adjustment in existing contracts, it found that most EU countries have moved toward a system that allows some type of rent indexation to consumer price inflation or various freely negotiated adjustment clauses. Denmark and France use explicit indexation to housing costs, while Sweden has a collective bargaining mechanism. While most countries have moved toward decontrolling rents in new contracts, this move has sometimes been limited to specific segments of the rental market, such as newly built houses (as in Denmark) or more expensive segments of the market, furthering regulatory segmentation of the rental market. Sweden seems to have the most restrictive mechanism in that regard, disallowing individual negotiation with prospective tenants.

Conclusions

There can be no doubt that excessively restrictive rent and tenure regulations have been a major cause of policy failure in rental housing markets. In particular hard rent control can be seen as a classical example of long and destructive policy lag. Liberalization of obsolete rent control systems has been found to stimulate the private rental sector.

At the same time, we observe that markets with deep rental housing sectors have elaborate tenant-landlord regulations, which intervene in material issues of the contractual relationship. These issues should be assessed item by item:

- *Tenure security*: While permanent contracts with limited options for termination by the landlord may have distortionary effects, these effects are lessened in systems that allow roll-over of investment costs and have liberal rent adjustment mechanisms. For an emerging market, shorter default tenure durations, perhaps five years, would be advisable to minimize risk. A pure roll-over system, with short contract durations and symmetric call options, carries the danger of high tenant turnover and adverse selection of tenants, as higher-income tenants seek tenure security as homeowners.
- *Rent control*: The classic direct price control has been discontinued in developed markets. After decades of political fight, soft forms of usury control have proved their suitability in practice. For example, the comparative rent system allows relatively free rent setting within an empirically determined hedonic rent distribution (differentiated by quality and location factors). Usury is defined at relatively high mark-ups over average recorded rents.
- *Removal of rent subsidies*: There is no easy political solution to adjusting artificially low rents of large numbers of sitting tenants, who are also voters. However, combining such rent increases with temporary rent allowances for certain household groups have proven successful in eastern Germany and seems a promising avenue.

Support for Private Rental Housing Investment

Rationale

Sufficient institutional structure, options to limit liability and deduct costs from taxable income, and access to funding are pivotal for investment conditions in the rental market. In many jurisdictions, small rental investors become discriminated against in favor of corporate investors in that regard.

Evidence

There is little conclusive analysis about the impact of institutional form on private rental investment. It seems clear, though, that reliance on corporate investors is insufficient to secure a broad and downward-penetrating formal rental market.¹¹⁵ Likewise, a “cottage” private rental industry of small private landlords alone seems undesirable, because of its low investment generation capacity and lack of professionalism. Small private landlords also face difficulties in limiting personal liability and securing a conducive tax status, which frequently is limited to corporate investors. Crook and Kemp (2002) find that in the United Kingdom small private landlords received systematically lower investment returns than corporate investors.

Dübel and Pfeiffer (1994) reviewed the European private rental sector for the EU Commission and found that unfavorable taxation treatment was partly responsible for the secular decline of the private rental sector, even in countries that did not practice or had abandoned rent control. Channels of distortions were the relative user costs of capital between renting and owning (see above), disallowance of cost deductions for small investors, and insufficient fit of tax support with the cash flow profile arising from a rental investment. It is instructive to compare three types of taxation approaches to small private landlords:

- The United Kingdom applies a good investment concept to rental housing, in which expenditures are deducted from rental income when determining the income tax base. However, the tax advantage through offsetting losses in the initial years is insufficient to compensate for the cash flow shortfall of a leveraged investment, which will force landlords to reduce leverage and return and increase rents. In the United States, even the possibility of offsetting losses from rental income was curbed in the 1990s.
- Ireland (in special business promotion schemes) and Germany (as a permanent policy), apply taxation concepts that subsidize the investment cash flow in the early years by creating fictive tax-deductible depreciation rates. Because cash flow gaps are lower, the leverage and profitability of the investment will be higher, or rents lower. At the same time, direct rent subsidies are avoided.
- A third class of taxation systems, then applied in France and Spain, penalizes rental investment through gross rent taxes and other additional burdens on cash flows.

Should a promotion concept follow the pure investment good concept or pursue a tax support strategy? The German experience suggests that although tax support leads to the intended reduction of the general rent level and a modern private rental housing sector, it has strong unintended consequences in the form of increases in urban land prices and rising barriers to

¹¹⁵ Dübel and Pfeiffer (1996) found for South Africa that corporate rental housing investors had disappeared from the market within a few years because of announced legal changes and the perception of increased political risk.

homeownership. The pure investment good approach proved insufficient to stimulate the sector. The U.K. government therefore during the 1980s and 90s experimented with various schemes, including Business Expansion Schemes and Housing Investment Trusts for institutional investors, that had little success.¹¹⁶ In contrast, Ireland appears successful in attracting new investor classes to the market with relatively deep tax support; however, support levels could not compensate for, and possibly contributed to, the house price and rent effects of a booming housing sector.

The availability of finance has been a major impediment for the sector, particularly for small private landlords. Permanent tax support schemes have been used in Germany to comfort banks about the creditworthiness of rental investment; however, experience in areas of market declines has demonstrated that permanent support may give rise to imprudent underwriting decisions. Nordic countries have used loan guarantee and interest support schemes for the private rental sector, often linked to some form of rent control or social targeting. At times, favorable market conditions have led to the emergence of rental housing finance as a product: in the early 2000s, with rising house prices and declining interest rates, a vibrant buy-to-let lending market developed in the United Kingdom. It is not clear at this point how stable that market will be. The predominant adjustable-rate mortgage lending system in the United Kingdom exposes rental investors to mismatch, should interest rates increase.

Conclusions

Next to market-oriented rent setting, the stability of investment conditions is a precondition for a thriving private rental market. Both corporate or institutional investment and small private investment can be stimulated at reasonable costs to broaden supply sources and expand the downward reach of the sector.

- Key investment conditions for small private landlords are a balanced tax framework that allows cost deductions from rental income and netting of rental losses against other income as well as access to bank finance.
- Gross rent taxes should be avoided. Access to finance for letting purposes should be treated within the general policy framework for the retail mortgage market. While the risk of rental housing finance may be higher than for owner-occupied finance, there is no reason for regulators to generally discourage banks from entering the sector. However, regulatory standards should be formulated that provide a framework for risk management.
- The corporate investor market needs similar stable tax and accounting conditions; owing to idiosyncrasies, that may require special schemes. Corporate investors react more quickly to market signals than small private investors, which often face investment constraints. Stability of the legislative, accounting, and taxation framework is therefore of pivotal importance.
- As the example of several Western European countries shows, a support strategy of special tax incentives for a private sector in its infancy can help mobilize new investor groups. If such a strategy is temporary and “sunsetting,” it will limit subsidy exposure (and technically be covered by the admissible state aid conditions in the EU Treaty).

¹¹⁶ For a critique, see MacLennan (2001).

Local price elasticity conditions should be observed to ensure that subsidies flow into rents, rather than landowner profits.

Institutional Requirements

Rationale

The implementation of rational housing policy requires a minimum infrastructure of specialized institutions and experts that design, formulate, implement, monitor, and independently evaluate policies. Those institutions should be free of conflicts of interest with, for example, the construction or finance industry.

Evidence

The quality of institutions is pivotal for the success of housing policies. Dübel (2004) identified failure to build sufficiently strong housing policy institutions and consolidate housing policy budgets under a single management in Central Europe as part of the cause of high housing subsidy costs and low program performance.

Monitoring by creating, maintaining, and publishing a database of program costs, outputs, and beneficiary incidence, and supporting independent evaluation is similarly crucial to success. The Czech government, for example, maintains a model monitoring and communication system, which keeps both public and evaluating institutions abreast of housing policy trends. Similar high-quality systems exist in the United Kingdom, the Netherlands, and Sweden.

Where insufficient institution building is not a general problem—for example, in Western countries with developed institutions in the government, agency, and banking sectors—political conflicts of interests may reduce the effectiveness of the system. An example is the United States, where independent evaluators largely agree on the existence of a wasteful housing policy bias toward homeownership, while the political clout of both the mortgage industry and the homeowner lobby in the Congress precludes any significant policy change.

The combination of low institutional capacity and high levels of conflict of interest may have most dramatic results: Hegedüs and Somogy (2004) describe the extreme subsidy costs of the Hungarian mortgage finance system, stemming from conflict of interest in a country where the largest mortgage lender dominates the sector and little government capacity exists to undertake independent formulation, implementation, and monitoring.

A way out of this trap has been international bodies that set and enforce policy standards. In Europe the European Union has some, albeit limited, powers to influence mortgage market policies—for example, if cross-border trade is affected. However, the influence on national housing policies is very small, because of limitations in the EU Treaty that assign housing policy to the subsidiary policy ambit. Still, EU rules about state aid (Articles 88/89 of the EU Treaty) and relevant interpretations of the Directorate-General for competition provide valuable guidelines.

Conclusion

Transition countries should develop a minimum public, agency, and private infrastructure for policy formulation, implementation, and evaluation. As long as housing is a priority for public policy, capacity in government should be adequate and independent. Also, housing-related subsidy budgets should be consolidated—or, at least, housing should be given formulation and

intervention rights. Program and sector data monitoring is key and should be organized under housing policy. An independent evaluation capacity, ideally within the private sector, should be established to regularly evaluate program efficiency.

ANNEX 2

DESIGN OUTLINE FOR RENTAL HOUSING SURVEY

Objectives

The objective of the rental housing survey is to provide an introductory analysis of supply and demand conditions in the rental housing sector in a given country. A particular objective is the rapid identification of market- or policy-induced development obstacles for the sector. The survey should identify follow-up work programs to encourage specific policy measures or programs, if necessary.

Methodology

The policy-oriented approach proposed requires a standardized screening format of the main demand and supply factors in a given market. This requires combining a variety of techniques, including empirical surveys and legal, financial, and microeconomic analysis.

Prior availability of datasets crucially determines the work program that can be realized within a given budget constraint, especially on the demand side. Fundamental is the existence of disaggregated household surveys, and possibly building censuses or surveys, that provide a minimum of information about tenure and housing conditions. In countries that do not undertake such regular analyses, an ad hoc household survey covering both rental tenants and homeowners should be considered.

These surveys should yield a basic understanding of age (life cycle), income, household type, and other standard predictive patterns of tenure. They should identify rent and housing cost burdens, both absolute and in relative terms between rental forms and rental and owning. Based on financial and housing markets parameters available, a threshold analysis to homeownership should be performed, to identify the share of tenants with the potential to upgrade to homeownership.

On the supply side, the investor structure in residential rental assets should be identified and described. Investors include small private landlords, professional landlords, institutional private landlords, and public landlords. The supply-side analysis should especially focus on addressing the determinants of rental supply informality.

The legal configuration of rental contracts and tenant-landlord relations needs attention. Particularly important are disclosure, formality, tenure duration, rent setting, and termination rules. The legal analysis should be contrasted with market practices, including in the informal sector.

The taxation environment of rental housing is of special importance for stimulating formal rental housing supply. Together with hard rent controls, taxation presents the key obstacle to rental sector formality and profitability.

The building regulation environment should be scanned for possible obstacles. It critically determines the profitability of investment—through capital gains mechanisms (conversion laws), for example, but also through general use and building type restrictions (urban planning laws) and transaction costs (building regulations). Also, the financial conditions for potential rental housing investors requires discussion of the typical dimensions of liquidity risks, credit risks, and market risks. For instance, the market risk characteristics of refinancing rental housing

investments (adjustable versus fixed-rate lending) determine which (legal) form of rent adjustments are feasible.

Downstream and upstream market conditions should be assessed, such as the supply structure for management of rental premises (relevant for public housing), the market for development of apartment buildings and the land market. Policy recommendations for a comprehensive approach to rental housing should be made with the help of an international best practice comparison.

Typical Tasks

The following is a list of typical tasks, derived from earlier work of the author.

1) Gather stylized facts on the rental housing market (economist):

- *Tenure structure/rental housing stock*: exploration of existing disaggregated household datasets and comparison with available tenure structure data. Description of tenant types and quantitative representation with the help of disaggregated datasets, additional surveys.
- *Market*: Identification of main rental market segments and regional/urban-rural differentiation.
- *Prices and affordability*: Assessment of rent levels, variations by location, quality, urban versus rural location, investor type, rent level changes over time. Assessment of non-rent housing and transport costs and determination of rent-to-income ratios. Collection of available sale prices for rental and owner-occupied units.
- *New construction of private rental housing*: Construction dynamics by location, quality, urban versus rural location, investor types.
- *Conversion analysis*: Speed and transaction costs of converting rental dwellings into condominiums/non-housing uses. Typical cases.

2) Analyze rental law and rental contracts (lawyer):

- *Tenant-landlord relationship*: Form of contract, contract duration and conditions for termination, financial conditions, enforcement of contract. For unregulated issues: typical forms of contractual provisions in the formal sector.
- *Rent control/adjustment of rents*: Determination of rent level in new contracts, adjustment in existing contracts.
- Other applicable consumer protection and contract law.
- *Institutional environment*: For contract enforcement, litigation. Assessment of cost and speed of litigation.
- Empirical forms of rental agreements, including informal ones.

3) Analyze tax/subsidy and financial environment (lawyer/economist):

- Tax treatment of rent revenues, operating and financial expenses, up-front expenses. One-time taxes and fees for rental property acquisition/construction. Estimation of taxes as a percentage of investment value and current cash flows.
- Assessment of typical equity and debt financing instruments for rental housing investments (type of equity schemes, duration, financial conditions and sources of lending).
- Stylized investment calculation for main investor types under the assumption of construction of a low-cost unit: up-front costs/initial rents and expected rental growth/assumptions over financing and operating costs/loan-to-value ratio, determination of before and after-tax cash flows, and calculation of return on investment/return on equity.
- Empirical values for typical returns, on investment and on equity, and comparison within a capital-asset pricing context (risk-return efficiency frontier).
- Comparison of user costs of capital with homeownership situation (economic/socialized housing), and alternative investments.
- Assessment of types/level of fiscal support needed to create a level playing field between rental housing investment and other investment with comparable risks (user costs of capital approach).

4) Analyze building and land regulation environment (lawyer/economist):

- Legal analysis of conversion laws, zoning laws, building regulations, and other regulations concerning rental housing. Comparison with treatment of homeownership, public housing, commercial real estate investment.
- Assessment of cost implications and degree of prohibitiveness of specific regulations and proposed reforms.

5) Analyze investor structures and individual support approaches (economist):

- Financial typology under country law for the principal investor types: institutional investor (life insurer or property trust), individual small landlord, small enterprise/professional landlord, public and non-profit landlords.
- Assessment of typical investment strategies of the principal investor types. Assessment of management capabilities. Identification of obstacles to investment in rental housing specific to principal investor types.
- Identification and characterization of typical forms of social entrepreneurship in rental housing outside formal sector rental housing investment, such as cooperatives, that might be attracted to the sector.

6) Analyze downstream and upstream market conditions (economist):

- Assessment of value added provided by typical rental housing investors (vertical integration).
- Downstream (output) market analysis:
 - *Subletting*: Empirical assessment, legal fringe conditions of market for subletting rental units. Typical contract conditions. Interaction with primary rental market conditions (rent control).
 - *Management of rental units (separation of investor and management function)*: Empirical significance and legal conditions of market. Characterization of supply-side or typical contract conditions. Analysis of potential use for public rental housing.
- Upstream (input) market analysis:
 - *Property development*: Analysis of typical building technologies, price structure, and competitive situation in the market.

7) Analyze the informal rental housing market (economist):

- Stylized facts along the lines of 1). Size of the market in main cities.
- Analysis of tenant-landlord relationship and the role of public sector. Impact analysis of existing public policy approaches.
- Sample survey of informal dweller households: type and frequency of rental relationships, income/expenditure and wealth, housing costs and affordability, housing needs, housing preferences, and attitudes.

8) Identify international best practice of private rental housing (economist):

- Successful private rental housing development strategies.
- Successful development strategies for the informal rental housing market.
- Analysis of private rental housing development strategies of income and regional comparator countries.
- Best practice of rental housing allowances (short assessment of principle feasibility for the case country with the help of empirical results obtained from the parallel homeownership assistance study).

Expected Survey Output

The survey should deliver an empirically and conceptually consistent policy menu for policy makers:

- The main lines of an economic development strategy for the rental sector.

- Proposal for changes or amendments to existing legislation and regulation (for example, on tenant-landlord relations and rent control).
- Proposal for a fiscal support strategy for rental housing that is consistent with overall macroeconomic and housing policy goals.
- Recommendations for existing public rental housing policies. Proposals for a differentiation of the social housing sector—for example, through PPP models or other.
- Development of strategies for the informal rental housing market, or the conditions of its conversion into formality.

These recommendations should be publicized in a suitable manner and presented to involved policy makers in legislative and executive bodies.

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