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 considerations
- Increase with income uncertainty, individual search activity for jobs, divorce incidence, and need for mobility;
- Decrease with household size, importantly influenced by household type
- 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

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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.\textsuperscript{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,\textsuperscript{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).

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?

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

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

**Figure 2. Building Structure and Rental Tenure in Some Market Economies**

<table>
<thead>
<tr>
<th>Country</th>
<th>Apartment &amp; hostel buildings</th>
<th>Non owner-occupied tenure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>30</td>
<td>70</td>
</tr>
<tr>
<td>Netherlands</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>United States</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>Denmark</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>France</td>
<td>30</td>
<td>70</td>
</tr>
<tr>
<td>Germany</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Spain</td>
<td>60</td>
<td>40</td>
</tr>
</tbody>
</table>

*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).*

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 sub-markets 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. 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 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

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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.
- 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**

![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). 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. 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).

**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. 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

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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%.

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.
be studied by the Bank in upcoming economic and sector work. 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.

Rationale for Tenure Choice Policy

It is beyond the scope of this 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. 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

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.
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.