A Proposal For:

Improving the Legal Relationships Between
Tenant and Landlord in Egypt

by

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I. Historical Background

Since the early 1950's, the A.R.E. has enacted a series of laws which defined the rents for housing and changed the rights of tenants and landlords. Under Egyptian law, the ownership of property normally carries with it all the rights of occupancy, use and utilization. Between 1952 and 1961, the rights of property owners were successively restricted in two ways. First, the rental income received by the owner was limited to a fixed amount - set by law. Second, the owner was denied the right to determine the utilization of his property within this rental income. The latter right was lost since the current tenants of a property were given the permanent right to occupy it as long as they paid the rents specified by law. The owner, therefore, was unable to change tenants, alter the use of his buildings, or collect a market rent. At the same time, these utilization rights were not wholly transferred to tenants. The tenant acquired only the right to use the property himself - not to utilize it in any other manner economically desirable. Thus, the rights lost by landlords were only partially given to tenants. The residual power - to use property in ways besides self-occupancy - was lost altogether.

During the early years of these laws, their impact was relatively modest. With little inflation occurring, the difference between market income of property and that allowed by law, was small. In addition, the number of tenants wishing to move, and the number of owners desiring to change the use of property was also few. As time progressed, however, the effect of the laws became more severe. Housing costs, and therefore, market rents, grew substantially greater than those permitted under rent control. The growth of Cairo and other Egyptian cities created new needs and demands for buildings, which could not be met, since no one has full control over utilization. Under these circumstances, the implicit "value" of the utilization rights lost by landlord, began to grow. In an attempt to recapture some of this new "value", landlords began to charge black market key money for new or vacant apartments. Tenants objected, but made payments realizing that the occupancy which they were achieving was in fact worth more than the official rent. Both parties seemed to be growing more dissatisfied with the system.
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This paper presents an analysis of how the Egyptian rent control system currently works in practice as well as law. The paper also presents a proposal to remedy the growing dissatisfaction with the system. The proposal has two objectives. First, to at least partially compensate property owners for the loss of utilization rights that occurred under the original law. Second, to alter the nature of tenants' rights so that full utilization of property is allowed. In this sense, the proposal is to recapture the full right of utilization that was originally lost to both parties, and insure that the benefits which result are equitably distributed between tenant and owner.

II. The Effects of Egyptian Rent Control

The impact of Egyptian rent control may well be different from that in other countries because it appears to be widely circumvented in a particular manner. Since the rights of tenants in Egypt are fully preserved as long as the official rent is paid, landlords are unable to charge any additional black market rent. On the other hand, the widespread reliance on cash, in business transactions, makes it very difficult to prevent the charging by landlords of an initial entrance fee (key money) to cover some or all of the unit's cost. Over the last decade, housing costs have increased to four or five times the level which can be financed with official rents alone. The current evidence is that during this period, key money has become very widespread, and in fact, has been the major source of income - especially in newer buildings. Much of the analysis of rent control in Egypt, therefore, is based on the assumption that this particular form of circumvention widely occurs. The effects of rent control are not likely to be similar in other countries unless comparable systems of avoidance exist.

(1) Rent control has had a very beneficial effect on the distribution of income by preventing enormous windfall profits to Egyptian landlords. Without control, the housing cost inflation of the last decade would have increased the rental income from existing real property five-fold. Since landlords as a class are much wealthier than tenants, any such transfer of income would have been extremely regressive. Any change in
tenant-landlord relationships that might release enormous profits, must in turn insure that they are redistributed in a manner which is socially equitable and economically progressive.

(2) A system of rent control which is circumvented with key money acts implicitly like a "turnover" or transaction tax. Key money payments are made only when a vacant unit (either new or old) is occupied or re-occupied. In the case of an existing apartment, a tenant can bargain with his landlord for only some fraction of the key money a new tenant might offer, while being forced to pay the full amount himself to acquire a different apartment. Thus, there is a strong incentive not to move. This prevention of turnover creates several serious inefficiencies in the operation of the housing and labor markets.

a) The movement of labor may be inhibited between cities. By discouraging relocation, rent control with key money can prevent the utilization of labor in the most productive regions.

b) Within cities, the rent control system discourages families from seeking a new, and presumably closer, apartment if the family head's job changes. Over time, this may force workers either to commute farther, or seek better employment less often, than would be the case without rent control.

c) As family structure varies over time, the housing needs of people change substantially. By encouraging people to live in the same apartment over their life, and then their children as well, the rent control system prevents the best utilization of housing. Families will normally exchange housing in the market to better satisfy their needs. Such trading is discouraged with rent control.

(3) The rent control system with key money circumvention creates a great deal of horizontal inequity, that is, there is unequal treatment of otherwise equal families. One's fate in the Egyptian housing market may depend more on chance, inheritance, history, or the presence of relatives with housing - rather than effort or work. This can result in envy, spite and general social tension.

(4) The current rent control system penalizes younger families and those who migrate while benefitting families which are older and more established. The young and the migratory (mostly rural-to-urban) are
generally poorer, and so the implicit effect of requiring payments for only new or vacant housing is probably regressive. Equally important, among the new families trying to acquire housing, those with wealth are far better off than those working hard to earn good income. One cannot finance key money and, therefore, pay for housing from income, since there is no collateral to secure the loan. Instead the payment must come from saved or inherited wealth. In all countries, wealth is much more concentrated and unequally distributed than income. This is an additional reason why the current system is regressive.

(5) Because of circumvention, rent control has not had as serious an effect as it might have on the incentives for constructing new housing. The official rents allowed for newly constructed units do not come near to covering costs. The major redeeming feature of the key money circumvention system is that it allowed some new construction to continue thereby avoiding a more serious housing shortage.

(5) Rent control, even with key money circumvention, has hastened the deterioration of buildings and prevented the more efficient adaptation or conversion of the existing housing stock. Since key money is a lump-sum payment, there is no incentive for a landlord to maintain a building after the payment has been made. Similarly since tenants cannot move, it is impossible to convert or subdivide older units into a number of newer, smaller ones. Only if a unit becomes vacant, and the key money is higher improvements or alterations, will the landlord have an incentive, during vacancy, to remodel. Since the key money system prevents turnover and vacancies, however, such improvements rarely occur. Thus fewer, and less useful housing units are obtained from the existing stock of buildings.

III An Evaluation of Some Alternatives

The M.I.T./Cairo University Housing Economy Subproject has considered five alternative changes in the current Egyptian rent control system. While all of them may not be politically feasible or economically desirable each has at some point been either discussed or implemented in other countries. As will become apparent, the subproject team clearly believes
that the last alternative is feasible in Egypt, and would represent a marked improvement over the current system.

A. The Status Quo - Continuing Control with Circumvention

The subproject team believes that circumvention is an inherent aspect of the current rent control system. In effect, then, continuing the present system amounts to continuing the six impacts discussed in the previous section. The advantage of doing so is clearly that excessive profits to landlords, and economic hardship to tenants, is avoided. The disadvantages are that the housing stock will continue to deteriorate and be inefficiently used, mobility will be inhibited, and selected groups in the population will suffer, while other groups benefit, more than would otherwise occur.

B. Complete Decontrol

The complete decontrol of all housing in Egypt would exactly reverse the effects discussed before. Mobility in the housing market would increase, maintenance and conversion would occur, and young people seeking new apartments would be better able to afford the high rents than current key money. The majority of the population, however, would experience great hardship while a smaller minority of landlords would greatly benefit. As between this and the status quo, the subproject prefers the latter. The team does not advocate complete decontrol.

C. Adjustments in Legally Specified Rents

This alternative has been frequently suggested to the team in Egypt. It would raise the controlled rents on existing units slightly (so as to encourage maintenance), and then set the rents of new units to cover true cost (so as to prevent key money). This proposal would not seriously change the distribution of income between tenant and landlord (impact 1), but then it would also not improve the efficiency and mobility of the existing stock or restore horizontal equity (impacts 2 and 3). What it would do is to allow young people to pay for new apartments more from their income rather than wealth (impact 4). Finally, the project does not believe that raising official rents would have the desired effect of improving the maintenance of units. For there to exist an incentive to building owners, rent must visibly change as a consequence of maintenance.
Any fixed rent does not have this incentive.

D. Adjustments in Legal Rents with the Proceeds going to New Construction

This option, like that above, would increase the rents somewhat on existing housing, but unlike option C, the increased rents would go mainly to a government fund rather than landlords. The government, in turn, would use the fund to subsidize the cost of new construction. This proposal would not encourage greater housing maintenance, nor would it increase residential or employment mobility (impacts 2 and 6). It would, however, assist younger families through subsidization (impact 4) and this, in turn, could encourage new construction (impact 5). In these respects, then, it is like option C, except that through the government fund, the higher rents in older units are transferred to younger families in newer units. This may at least somewhat improve horizontal equity (impact 3), although it continues a policy of subsidizing new construction. The costs of this subsidization would increase over the years becoming an ever larger burden. Administering this system would also be a problem, because at some time after construction, each unit must switch from receiving a subsidy to paying for them, and the rents on all old units must be adjusted upwards.

D. Vacancy and New Construction Decontrol

This system has been used sometimes in developed countries as a way of eliminating rent control gradually over time. New units are completely decontrolled, and old units are as well, whenever the current tenants move or pass away. It again does not change the relative income of tenants and landlords, nor does it improve horizontal equity, mobility and occupancy efficiency (impacts 1 through 3). Like option C above, however, it would allow new families to rent housing with their income rather than being forced to buy occupancy from their wealth. Finally, slowly over time, vacancy decontrol would allow portions of the existing stock to be upgraded, improved or converted. To this extent, it is slightly superior to option C.

E. Reforming Ownership and Tenancy Rights

The M.I.T./Cairo University Subproject believes that by carefully restructuring the legal rights of property owners and tenants, all of the adverse effects of rent control can be overcome without losing any of its
advantages. The suggested restructuring of rights involves four points:

(1) An occupancy right or permanent legal lease will be created for each housing unit - separate from the property or ownership right. The occupancy right and the property right are fully transferrable and any individual may own either, neither, or both of them.

(2) The property right to a unit is a legal entitlement to permanent rental income - as specified by law - to be paid by the holder of the occupancy right.

(3) The occupancy right is a legal entitlement to the use of the apartment in any manner. It may be lived in, sublet or rented, altered or improved. The holder of the occupancy right is legally responsible for: paying the fixed rent to the property owner, paying taxes, maintaining the unit in any manner specified by other laws.

(4) For units now under construction, or to be constructed in the future, the developer and/or builder will receive both the initial property and occupancy rights. For existing units, there could be two options:

a) Owners would receive the property right whose fixed income would equal the existing official rent. Tenants would receive the occupancy right.

b) Owners would receive the property right, whose fixed income would equal the official rent. Tenants would be able to acquire the proposed occupancy right if they accepted a modest increase in the official rent - to be specified by law. This new rent would then become the fixed income of the property right. If tenants chose not to exercise this option, their rent and rights remain as currently specified by law.

This proposal attempts to accomplish two objectives. The first is to free up the housing market and make it easier for young people to acquire units. This is achieved in the proposal by making the occupancy right transferrable. Since tenants can sell their right and buy another, or convert and sublet their existing units, personal mobility and the adaptability of housing are improved. Subletting will create market rents, whose variability will also provide an incentive for maintenance
and allow young families to find rented housing without the constraint of wealth. New construction should also be somewhat encouraged because owners can charge rents to cover their costs without engaging in any "illegal" activity. Thus in most respects, the proposal creates a free housing market with all of its advantages.

The second objectives of this proposal is to divide the profits or gains that result from this market activity in a way that is socially just. In proposal 4a, landlords would be no worse off, while most of the gains would go to tenants. The income to landlords would remain constant, and in fact would be freed from the current burden of taxes. Tenants, on the other hand, would receive the entire "value" of a transferrable occupancy right. In the market that develops, these should be worth no more than current key money payments. As progressive as this scheme might be, two objectives could be raised. It might deny landlords too much to be politically acceptable, while at the same time the gains to tenants would vary substantially by when they acquired their apartment. Older tenants have a lower official rent and so their occupancy right would be worth more. Thus, in a sense, the horizontal inequity of the present system would not be corrected. Option 4b attempts to rectify both of these issues. By giving landlords some increase in rent, they receive, in effect, some of the "value" which accrues to tenants. In fact, as the official rent associated with the owner's property right goes up, the market value of the occupancy right will fall. At the same time, it would seem possible to specify the pattern of new rental payments so as to correct current horizontal inequities. For example, a tenant in an old building might obtain his occupancy right by doubling his rent (from say 5 to 10 L.E. /month) while tenant in a new, similar, unit could do so with no rent increase (because his rent was already 10 L.E.). If the rent increases necessary to obtain occupancy rights are equal, then the gains to all landlords will be the same, while the value of occupancy rights for identical housing will vary across tenants. If the increases in rent equalize payments for identical housing, then the gains to landlords will vary, while the value of tenant occupancy rights for equivalent housing will be the same. Clearly, the

* See example in Appendix I.