

Comment on Franz Hubert: Rent control: Academic analysis and public sentiment

Tore Ellingsen^{*}

A benign view of rent control is that private contracts are inefficient. In particular, they do not provide tenants with enough insurance against price hikes. It is easy to agree that the State or other political bodies can have a role to play in the housing market under extreme and unforeseen circumstances, like wars. It is less clear why rents should ever be politically regulated under more ordinary circumstances. Hubert's paper illustrates the point nicely. The housing market is surely imperfect in several ways, but rent control is typically not the best way to correct these market failures. Essentially, what Hubert says is: If rent control is the solution, we have not yet understood what the problem is.

Towards the end of his paper, Hubert speculates that rent control could be a way of protecting naïve tenants against clever landlords, and invites economists to develop theories along these lines. I doubt that this argument will go much further than those Hubert has already so eloquently rejected. Indeed, my conviction is that concern for the general good cannot explain the regulatory schemes we observe. Rather, I believe that political intervention in housing markets primarily serves insiders at outsiders' expense, and frequently does more harm than good.

Consider Stockholm's "second generation" rent ceiling. Rents for attractive old apartments are far below the market clearing level, queues are long, and the black market is huge. Interestingly, the stringency of rent regulation has evolved gradually. The regulation was originally not even intended to depress rents below market clearing levels, but as market prices increased, the regulated price did not follow. Could this be the result of an optimal housing policy? A defender of the system could of course argue that the system effectively insured the original inhabitants against the upward price pressure in the Stockholm region. According to Hubert and others, efficient in-

** Tore Ellingsen is professor at Stockholm School of Economics.*

insurance against rent increases is hard to provide in a purely private market.¹ While some of the theoretical arguments for contractual failures are reasonably compelling, my view is that simple and realistic contracts can provide quite adequate insurance. For example, rents can be fixed relative to some price index, with major rent increases occurring only between tenancies.

For the sake of argument, let us suppose that many tenants fail to realize the need for insurance. The state may then have a role in standardizing the contract so as to protect the tenant against sudden price increases; see for example Arnott's discussion of tenancy rent control. In Stockholm, unlike the tenancy rent control system favored by Arnott, rents are not allowed to change only because a tenant leaves. A possible justification for the general rent freeze would be that households' size varies over the life-cycle, and that households would want to be insured for the whole duration of their stay in the region. By controlling rents and allowing swaps of rental contracts, both insurance and some mobility are facilitated. However, this argument invites at least two objections. First, there seems to be no reason why an apartment that is vacated by an insider leaving the region (or even the world) should be put on the "market" at the previous rent level. That is, why should apartments be allocated to newcomers by queue rather than price? Second, the argument does not explain why the tenant, possibly in cooperation with the landlord, cannot trade the contract for money. In particular, if the tenant had the right to sell the contract to another tenant without any change in the terms, subject to approval of the new tenant by the landlord (who might demand some compensation in return), all parties would gain. In sum, I doubt very much that any respectable economist, including Franz Hubert, would consider Swedish style rent regulation an efficient arrangement.

The alternative theory is that politicians interfere in the housing market primarily because the majority of voters gain from rent control. Although the majority's gains are considerably smaller than the losses incurred by the minority and non-voters, any politician worrying about re-election may end up catering for the voting majority rather than any measure of total social welfare. Epple (1998) has argued, theoretically and empirically, that regions are particularly prone

¹ May I add here that, in addition to the work Hubert cites, there are some relevant theoretical studies on endogenously incomplete contracts. In particular, Rasmusen (2001) discusses why complicated clauses are not proposed, even when they are efficient.

to impose rent control when there is an increase in demand and when the housing stock is highly durable. (See also Ellingsen, 2003.) Even though market rents are optimal from an “ex ante” point of view, a voter who can get access to a durable apartment has much to gain from rent control. In the short run, a rent ceiling merely represents a transfer from the landlord to the tenant. In the long run, there will be a smaller supply of apartments, and possibly lower quality, but today’s tenants are not among the chief losers.²

It is worth observing that even incumbent owner-occupiers ordinarily prefer rent control to an unregulated market, as rent control increases demand for owner-occupied flats. The only major losers from rent control are landlords and people who are currently without a dwelling in the rent regulated region, i.e., people who want to move into the regulated area and to some extent youngsters living with their parents. In the short run, these losers are few and they do not vote. In the long run, the losers are many. The biggest losers are:

- All those that are deterred from moving into the region because rental housing is unavailable and owner-occupancy is undesirable or too expensive, but who would have moved under an alternative rent-setting scheme.
- All those who purchase owner-occupied housing.

Since the losers either remain outside the jurisdiction or move in and become defenders of rent regulation, there just cannot be a political majority in favor of market rents unless supply or demand conditions change.

In a political economy framework, it is thus easy to understand why and where controls come about. As Ellingsen (2003) points out, it is also easy to understand the ban on trade of rental contracts. If rental contracts could be legally traded, even people who do not desire to rent an apartment would join the queue. If the median voter is without an apartment, or wants to have a larger one, he or she does not want competition from “speculators.” Only when the latent market price becomes so high that the median voter would consider cashing in and moving to a less attractive location will there be sufficient popular support for selling out rent regulated apartments to the ten-

² While new construction is often exempt from rent control, a rational landlord realizes that new construction will one day become old construction, and that tenants have an incentive to lobby for controls.

ants. The transformation of leases into owner-occupied houses in the last decade is an indication that this point has been reached in Stockholm.

To summarize, I think it is time to concede that rent regulation is an undesirable, yet natural, outcome of the political process. If we want to align housing policies more closely with general interest, two options present themselves. The first is to geographically expand the jurisdiction for housing questions, so as to let potential losers from rent control have a say. The main limitation of this solution is that the winners from rent control are usually much better organized than the losers.³ The second option, which I favor, is to impose nationwide restrictions on rent control.

References

- Ellingsen, T. (2003), The political economy of price controls, Manuscript, Stockholm School of Economics.
- Epple, D. (1998), Rent control with reputation: Theory and evidence, *Regional Science and Urban Economics* 28, 679-710.
- Rasmusen, E. (2001), Explaining incomplete contracts as the result of contract-reading costs, *Advances in Economic Analysis and Policy* 1, No. 1, Article 2.

³ Landlords are sometimes well organized, but potential future tenants are not. Some defenders of rent control worry about the landlords' windfall gain from deregulation. If fairness is a major concern, there should be a tax on these windfall gains.