Rent regulation: An introduction

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Economists have for a long time been almost unanimous in condemning rent controls. Yet, such controls are still operative in many housing markets all over the world, not least in Sweden. Does the longevity of controls indicate that the traditional arguments against rent controls are incomplete or even misleading? In order to shed light on this question, the Economic Council of Sweden organized a conference with leading experts in the area on November 8, 2002. This issue of *Swedish Economic Policy Review* presents the papers from the conference along with comments by discussants.

1. The historical legacy

If one were to design a legal framework for the housing market from scratch, it is inconceivable that one would end up with the systems we see today. Today's rent regulation systems have to be understood in their historical context. Several of the papers in this volume sketch the historical background. In most industrialized economies, emergency price controls on housing and other goods were introduced during both world wars in order to prevent landlords and other resource owners from taking advantage of the sudden scarcity. These first-generation controls effectively amounted to a freeze on rents, without taking costs or general price increases into account. Controls were generally dismantled after the wars, either abolished altogether or replaced by second-generation controls allowing some gradual increase of rents in relation to increases in building costs and the general price level. As a result of the oil crises, and the ensuing increase in inflation in the 1970s, such controls were reintroduced in many jurisdictions where they had earlier been abolished, e.g. in several U.S. cities.

With subsiding inflation in the 1980s and 90s, many second-generation controls were again abolished or transformed into a third

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generation of controls.[1] Under these more recent systems, rents are regulated within the tenure, thereby providing security of tenure for incumbent tenants, but are by and large unregulated for new tenants. This system has been termed tenancy rent control. Its effects are treated in Richard Arnott's paper.

It is striking that Sweden, where rents for all apartments are set based on negotiations between landlord and tenant associations, still employs a second-generation system. No distinction is made between old and new leases, and rent levels are far below market clearing levels in most of Stockholm and central parts of other major cities. The effects are but all too well known: illegal key money, a flourishing market for second-hand contracts, rapid conversion of rental apartment buildings into housing cooperatives (*bostadsrättsföreningar*), tenants locked into sub-optimal housing arrangements, new entrants to the housing market forced to live far from the center, etc.

2. What is known about costs and benefits of rent control?

In the first paper of the volume, *Steve Malpezzi and Bengt Turner* provide a broad survey of empirical studies of rent controls across the globe. As it turns out, a majority of the studies are from the U.S.; Manhattan, where regulations have changed in interesting ways, is the most intensely studied market. Like the other authors, Malpezzi and Turner emphasize the variety of control systems and, hence, the difficulty in drawing general conclusions. Most studies are devoted to first- and second-generation controls. While they may not be applicable to many markets today, they should carry lessons for Swedish housing politicians.

Most studies remain within a simple partial-equilibrium competitive-market framework. At the simplest level, a number of studies have tried to estimate the transfer from landlords to tenants by comparing regulated rents with rents on comparable units inferred from unregulated market segments. While such calculations may give a rough indication of the strength of rent controls, they completely neglect behavioral responses. A natural next step has been to take into account supply and demand responses and estimate traditional "triangle measures" of welfare losses. Typically, it has been found that the

[1] For a listing of reforms after 1980 in different countries, see the Appendix of the Malpezzi and Turner contribution to this volume.

transfer efficiency is low. The benefits for the recipients of a rent-controlled dwelling are much smaller than (often less than half of what) a simple comparison of controlled rent and estimated market rents would indicate. Studies for different household groups also show that costs and benefits are poorly targeted, and the controls have no consistent redistributive effects. Hence, rent regulations in general appear to achieve little in the way of income redistribution at the cost of considerable efficiency losses. More recently, several studies have focused on other dimensions of behavioral adjustment, like mobility and incentives for repair and maintenance.

3. Rent controls as a substitute for perfect contracts

In his contribution, *Franz Hubert* discusses public and academic attitudes towards rent regulations. While most economists remain critical towards rent controls in general, there has been some change of attitude in recent years. Almost a decade ago, Richard Arnott (1995) summarized some "revisionist" arguments in favor of rent control, arguments that have been articulated in theoretical models by, e.g., Arnott and Igarashi (2000) and Basu and Emerson (2000). The revisionist view is based on the fact that housing markets are heterogeneous search markets, characterized by imperfect competition. In such markets, rational landlords may use their market power to charge a rent above the marginal cost. High rents will induce new entry and lead to an equilibrium with higher vacancies than optimal. This inefficiency creates a role for rent regulation to prevent landlords from exploiting their market power. While this line of argument apparently justifies some forms of control, at least if shrewdly designed, Hubert argues that the reason why there remains some public support for rent controls is to be found elsewhere, and may conceivably be due to some fundamental departure from the "rational man" assumption routinely employed by economists.

Historically, most rent controls were initiated in emergency situations to avoid windfall income redistribution. Society stepped in *ex post*, not accepting the consequences of voluntary contracts being written between tenants and landlords. Interestingly, these controls appear to have been widely accepted also by the landlords at the time. Apparently, it was recognized that contracts are by necessity incomplete and there are emergency situations where society has the right to step in and correct undesired outcomes. Otherwise, many tenants would simply have been unable to pay the market rents. In effect, the rent freeze guaranteed security of tenure. In many countries tenure security, in one form or the other, is now legislated. Tenants cannot be evicted without a just cause. For such a rule to have any meaning, it must be coupled with a provision that rents may not be raised above general market levels, so as to prevent landlords from abusing their bargaining position.

Legislated tenure security would restrict the freedom of contract, i.e. it would make it impossible for a landlord to offer a lower rent today in exchange for unrestricted rents tomorrow. It may be questioned why the freedom to write contracts should be limited in this way. One reason is that the bargaining between landlord and tenant is often unbalanced, both in terms of information and ability to understand economic affairs. To counteract this asymmetry, rational tenants might seek legal advice, whereas other households—perhaps those who would need the advice most—would stand the risk of being cheated upon. Regulation may be seen as a way of prescribing a standard form of contract that everybody has to follow, thereby preventing too many resources from going into the legal sector. Systems of tenancy rent control may be seen in this light.

4. Tenancy rent control

Under tenancy rent control, rents are regulated within a tenure but are unrestricted when a lease is signed with a new tenant. As *Richard Arnott* notes, this is now quite a common form of regulation, employed in Spain, Switzerland, Japan, a number of U.S. cities, and elsewhere. Several countries also allow more generous rent increases between tenancies than within tenancies. Arnott's paper provides a systematic analysis of the effects of tenancy rent control along a variety of dimensions, a few of which we mention here.

Tenancy rent control provides tenants with insurance against sharp rent increases. It shifts some of the risk associated with altered market conditions from tenants to landlords. Presumably, this is a desired effect, since landlords may be better able to carry these risks, and since they would otherwise be borne disproportionately by households unable or unaccustomed to handling economic affairs. According to Arnott, it is not a priori obvious that the end effect will be to increase security of tenure. If landlords are prevented from raising rents unless the tenant moves out, they will have incentives to evict tenants, and there may be a need for legislation preventing them from using any lease infraction as a pretext for eviction.

A key set of problems relate to the effects on mobility. Tenancy rent controls only bind when market rents increase faster than the controlled rent level. Under such circumstances, tenants will gain from remaining in their current dwelling, even if their housing needs have changed. If regulated rents depart far from market rents, such lock-in effects may be strong, and the distribution of the housing stock will not reflect preferences. Low market mobility will also increase search costs in the market, thereby hurting new entrants and possibly reducing labor market mobility. At the same time, landlords will try to select households with a short expected duration. The equilibrium impact on duration is ambiguous in principle, but Arnott concludes that the lock-in effect is likely to dominate.

5. Rent regulation and new construction

It is self-evident that textbook first-generation rent controls will have negative effects on construction. The size of the effect depends on the elasticity of supply. With second- and third-generation controls, where landlords are allowed cost coverage for new dwellings, the effect on construction is less clear. Taking a dynamic perspective, *Hans Lind* notes that the uncertainty about future regulations is a crucial factor. The risk in new production may be higher under controls because of the risk that controls change. Under rent control, vacancies are often concentrated to the marginal parts of the housing market, i.e., to those areas where new construction is undertaken. Also for this reason, new construction is likely to be more risky with than without regulation.

During the economic boom in Sweden in the late 1990s, housing construction remained at very low levels in spite of a growing gap between regulated rents and rental costs on the unregulated market for coop shares. The low rate of construction has been a major concern in Swedish debate. Some commentators have put much of the blame on rent regulation. Lind tells a story where rent regulation only plays a small role. Important elements of his story are instead low supply elasticity (due to the planning process and lack of competition) and a shift in demand towards the city center. In recent years, the risk of future vacancies may also have been an important factor.

6. Effects on segregation

Recently, perhaps the most common argument in favor of rent control—at least in Sweden—is that it integrates rich and poor households. *Edward Glaeser* argues that the theoretical support for this hypothesis is quite weak. While rent control does reduce rents for tenants as long as they remain in their current apartment, this is only a temporary benefit accruing to an aging part of the population. Studies of New York rent controls indeed find that tenants in the controlled sector are much poorer but also much older than the average. The longer run effects depend on the mechanism allocating vacant apartments. Although queuing time sometimes matters for the allocation, anecdotal evidence suggests that other factors—like personal contacts with the landlords and the ability and willingness to pay key money—are frequently rather important in practice.

Rent control may increase segregation if it reduces the quality of the regulated dwellings, thereby maintaining pockets of low-quality housing in high-quality neighborhoods. Based on an empirical analysis of US data, Glaeser finds some support for this hypothesis. Finally, and highly relevant in the Swedish context, rent regulation increases the incentives for conversion to condominiums. Since richer tenants can more easily purchase their apartment, rent regulation may in the long run contribute to increasing segregation through this channel as well.

On balance, it remains unclear whether rent regulation has much of an impact on segregation, and if so, whether the effect is benign. Anyway, Glaeser concludes that other policy instruments are preferable if the aim is to reduce segregation. Removing the barriers to new construction will allow affluent areas to grow, and targeted housing vouchers may induce some poor families with school-age children to move to more affluent neighborhoods and better schools.

7. Conclusion

Economists generally agree that rent regulation is a defensible policy measure for short periods during and after unexpected crises. Recent research has tried to more closely assess the arguments for and against rent regulation under less extreme circumstances. The papers by Arnott and Hubert in this volume consider a variety of arguments in favor of mild forms of "third-generation" regulation, but in general, the theoretical justification for rent regulation is relatively weak.

Frequently, the equity and efficiency objectives that can be attained through rent regulation can be attained more efficiently either through voluntary contracting or through some other cheaper intervention. Similarly, Glaeser's paper suggests that rent regulation sometimes prevents social integration; and even when it does not, social integration can be achieved at a lower cost through other means. Finally, while Lind argues that rent regulation is often a relatively minor obstacle to new construction, there is certainly no reason to think that rent regulation encourages construction either.

In our view, therefore, the papers in this volume support economists' conventional wisdom: Peacetime rent regulation represents a political victory of tenants over landlords and of incumbent tenants over outsiders. The efficiency losses are sizeable. Although there is sometimes a case for redistribution from landlords to tenants, it is not clear that rent control is a good transfer mechanism. Certainly, regulations do not systematically favor poor tenants. Therefore, we strongly believe in regulatory reform. Legislation preventing peacetime rent regulation is a radical measure that is well worth considering. At the very least, countries with strict rent control systems should consider erecting institutions that curb the influence of privileged insiders over rent levels.

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