

Comment on Richard Arnott: Tenancy rent control

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There are numerous articles and studies that compare the efficiency of a competitive rental market for apartments to that of a market with rent control. The controlled market does not come out favourably in such comparisons because rent control can sustain allocations of the stock of apartments in which another household than that willing to pay the most for a particular apartment ends up as its tenant, the stock of apartments is badly maintained and there is an inadequate supply of rental apartments.¹ Those are potentially serious drawbacks of rent control but their practical significance depends on many factors. The degree of misallocation of the existing stock depends on factors such as how the controlled rents are revised as the general price level and market conditions change, the possibility for incumbent tenants to sublet their apartments at higher rents than the controlled rent and the efficiency of the black market. Inefficiencies as regards maintenance of the existing stock and the supply of rental housing can be, and in many cases are, mitigated by means of cost-pass-through provisions and production subsidies. That is, of course, not to say that negative efficiency effects of rent control can be or are completely eliminated in practice but statutory rules, subsidies and illegal activities mitigate the efficiency losses.

In many cases, advocates of rent control do not dispute that rent control may cause efficiency losses but instead they argue that it offers advantages in completely different dimensions. It may for example lessen the degree of income segregation in attractive areas. In ad-

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¹ Milton Friedman and George Stigler early criticized the rent control policy in San Francisco in an article entitled *Roofs or Ceilings?* (1946), later reprinted in Friedman, M. *Monetarist Economics* (1991). Weitzman (1977) and Wijkander (1988) show that there are in principle realistic second-best circumstances under which rent control might be an efficient policy tool. However, whether those circumstances are valid in practical situations seems very doubtful. Therefore, their results are primarily useful as negative results that demonstrate that bringing in segregation and income distribution into the analysis does not automatically make rent control an efficient policy.

dition, decontrol probably leads to a large redistribution of income and wealth from tenants to landlords where the latter group is relatively richer than the former.

The political debate about rent control that takes place in jurisdictions that apply some form of rent control evolves around the benefits of increased market flexibility, unwanted effects on the distribution of income and wealth, and increased income segregation if rent control is completely or partially dismantled. In practice, it is probably not possible to find a way to decontrol that hurts nobody. Therefore, decontrol is in many cases a highly sensitive political issue. In jurisdictions where rents are not controlled, there is hardly ever a discussion about introducing such a policy. That raises the question about under which circumstances rent control has come up on the political agenda and has been implemented.

1. Rent control is emergency policy

Let us start with a thought experiment. Consider a competitive, rather stable, uncontrolled market for rental apartments. What would the effects on that market be of an introduction of rent control that lowers rents slightly below the going market rents? First, the same tenants as before would occupy the apartments. Hence, those tenants who are willing to pay the most for them would rent apartments. That implies that there would be no inefficiency with regard to the allocation of the existing housing stock. Second, since the same tenants would occupy the apartments, there would be no effects on segregation. Third, there would be a slight redistribution of income and wealth from landlords to tenants. Fourth, incentives for adding to the housing stock would be slightly reduced. Fifth, provided there is no cost-pass-through provision, the incentives to maintain the existing stock would be reduced. It seems as if the important effect in the short-run is the redistribution of income and wealth from landlords to incumbent tenants.² The fact that rent controls are never introduced in stable situations indicates that it is probably not possible to obtain political support for such a redistribution, although it will probably benefit many and hurt only a few. A reason may be that the introduction of rent control in such a situation would be regarded as too much of an

² If rents were regulated at lower levels, the redistribution effect as well as the effects on maintenance and supply would be reinforced and there would also be incentives for black market transactions.

infringement on property rights and that this carries more weight than the current redistribution of income and wealth. Another reason may be that voters realize that rent control causes significant problems in the long-run.

So, under what circumstances is rent control introduced? In his paper, Richard Arnott points out that many rent controls were introduced at the time of World War II and the oil crisis at the beginning of the 1970's. The war period was certainly somewhat abnormal in that economies were geared towards supporting the war effort. Housing construction was not central to that issue. The period of the oil crisis was an inflationary period. A potential hypothesis is therefore that rent controls were introduced as emergency policies to prevent rents from increasing much and fast. Hence, without rent controls, there would have been large redistributions of income and wealth from tenants to landlords. That is, in these situations, the controls prevented redistribution from taking place instead of achieving redistribution, which is the case if rents are forced down under the market-clearing level under normal circumstances. It is highly likely that the introduction of rent control in such a situation is viewed as less of an infringement on property rights than it would be under more normal circumstances and therefore, the prospects of gaining support for the policy may be much better in that situation. However, that does not mean that rent control is the best way to protect tenants from the unexpected outcome of the market forces, but a rent freeze is a readily available policy with, in the short-run, very few drawbacks, except that it prevents a few landlords from getting rich. Alternative policy options may take considerable time to develop and implement. Meanwhile, rent increases would take place. Serious drawbacks of a rent freeze appear as the controlled rents fall far below market rents and the control is in place for a long period of time. For that reason, the intentions at the time when controls were introduced have in many cases been that these should be only temporary measures.

2. A political dilemma

In cases where rent control has been effective in the sense that it has shielded tenants from considerable rent increases, it may be politically very difficult to dismantle the control since that would imply a large redistribution of income and wealth from tenants to landlords. Also, it may still be very difficult to gather political support for decontrol

with some more or less clever scheme that taxes landlords for decontrol profits, so as to neutralize one side of that redistribution since the situation for incumbent tenants would still worsen. That may not be regarded as entirely fair, particularly not by incumbent tenants themselves, since they may not feel that they constitute a relatively wealthy group. In addition, during the period when rent control has been in place, policies that give preferential treatment to owning one's house such as tax deductions and subsidized loans may also have been implemented. Only dismantling rent control in such a situation raises a significant fairness issue. An additional problem with decontrol is that it may put a downward price pressure on owner-occupied housing which implies that owners of owner-occupied houses may not favour decontrol.

However, a rent control that is strict in its statutes, such as a rent freeze, and also strictly enforced may after some time lie as a dead hand over the market and cause problems not only for newcomers who want to rent apartments but also for incumbent tenants and people living in owner-occupied dwellings. It may, for example, be that tenants encounter large difficulties in case they need to adjust their housing because the family size has changed or their children may not be able to find adequate housing when it is time to leave home. The latter problem may also affect homeowners. This implies that it may not be completely impossible to gather political support for decontrol, but it is probably necessary that it does not hurt incumbent tenants too much and that it does not put too much downward pressure on the prices of owner-occupied housing. Many partial decontrols that have taken place have had these characteristics.

3. Feasible decontrol

Arnett's paper, in this volume, contains a very interesting and informative discussion about a type of rent decontrol that has shown to be feasible in some cases. That decontrol is a change from a rent freeze to market determined rents at the time when a new tenancy of a vacant apartment commences, but a frozen rent after that. Such a decontrol does not worsen the situation for incumbent tenants and since newcomers only represent a small fraction of the market, general equilibrium effects on house prices are probably negligible. The political resistance against such a decontrol can therefore be expected to be weak. In fact, it seems that the only self-interested resistance

would come from incumbent tenants that want to obtain reimbursement if they surrender their apartments or from people who feel that they lose something valuable when they lose the slim chance to obtain a contract for an attractive apartment at a bargain rent. However, as most renters are probably planning to stay put for a long time and people who expect to obtain a nice apartment at a bargain rent are few, the self-interested political resistance can be expected to be weak.

Exchanging a rent freeze for tenancy rent control indeed seems to be a step in the right direction from an efficiency point of view. However, one may ask if that is as far as it is possible to go without worsening the situation for incumbent renters? The answer is: probably not. Another type of tenancy rent control that could be worth considering when decontrol is contemplated is a combination of the type of control discussed by Arnott and the contract regulation in place in Belgium.

In Belgium, the rent for a particular apartment is market determined when a tenancy is commenced. That initial rent remains unchanged for two years but subsequently, it is adjusted each year according to an index for the development of rents on the local market, for example Brussels. The duration of a tenancy is nine years. After that period, the contract has to be renegotiated or the tenant has to move out. An interesting aspect of Belgian rent control is that it balances market flexibility with tenants' legitimate demand for protection against rent increases that are not motivated by changed market conditions.³ A combination of tenancy rent control and the Belgian form of contract regulation can be that each time a new tenancy is commenced, it is as under the terms of the Belgian contract regulation or something similar. It seems that this enhances efficiency as compared to only tenancy rent control without obviously meeting stronger political resistance than the type of decontrol discussed by Arnott.

Perhaps a decontrol to tenancy rent control or the combination of tenancy rent control and the Belgian contract regulation constitutes a possibility for Sweden where strong lock-in effects characterize some regional rental markets, in particular that in Stockholm. However, a few hurdles must be overcome. One of these comes from the statutes of the current rent control in Sweden and the other from its imple-

³ With competent renters, it is likely that unrestricted contracts between renters and landlords would comprise clauses that prevent landlords from unconditionally raising rents. But since renters are not lawyers, there is a case for government regulation which can take the form of the Belgian contract regulation.

mentation. Renters in Sweden have the right to exchange their rent-controlled apartment for another dwelling. The new tenant rents on the same conditions as the former. Hence, a renter may change dwellings with some other renter. In practice, they may in fact also use their rental apartment as a partial payment for an owner-occupied dwelling. According to the statutes, that is not allowed but it cannot easily be prevented when the exchange right is undisputed. It seems likely that renters in Sweden would require some compensation for the loss of such legal rights. Another hurdle is related to the implementation of the current rent control, which is the second-generation rent control in Sweden. In that system, rents are negotiated between the tenants' association and public housing corporations. The rents they agree on become a point of reference for private landlords who can charge a higher rent than the agreed rent only if they can show that their apartments are qualitatively better than those provided by the public housing corporations. In practice, the possibility to charge significantly higher rents than those agreed is quite limited. In case of dispute between renters and landlord, there is a special court with representatives from the tenants' association and the federation of landlords and also an independent judge, which settles the disputes. That organization of the market creates a prominent role for the tenants' association and made it a sizable organization. It seems highly unlikely that it would give up its position without gaining anything. A factor that exacerbates that problem is that the tenants' association is a branch of the social democratic movement, which is by far the most influential political movement in Sweden.

Rent negotiation is a very important legitimating factor for the tenants' association. Therefore it seems politically extremely difficult to move in the direction of market-determined rents. The largest prospect for reform, in the short-run, probably is within the current system, which in principle is flexible enough to allow outcomes that are not too different from market outcomes. However, in a longer perspective, a close to market outcome would create a legitimacy problem for the tenants' association and for that reason, it may not be willing to go very far in that direction.

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