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Tenancy rent control

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Summary

■ Many jurisdictions around the world now implement a form of rent control in which rents are controlled within tenancies but are free to vary between tenancies. This form of rent control is termed tenancy rent control. This paper examines the positive and normative economics of tenancy rent control when introduced into a previously uncontrolled housing market. Unlike traditional forms of rent control, tenancy rent control does not generate excess demand but instead induces a different long-run equilibrium in the market. Compared with the uncontrolled equilibrium, the tenancy rent control equilibrium entails some distortion but also improves security of tenure. Thus, tenancy rent control may be a reasonable compromise between those who favor extensive government intervention in the housing market and those who favor little if any. The paper does not discuss the effects of introducing tenancy rent control into a tightly controlled housing market such as Sweden's, beyond noting that doing so would entail partial decontrol. It should however be possible to adapt the paper's analysis to treat this situation.■

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1. Introduction

1.1. Rent control policy has been evolving[1]

The rent control discussed in most economics principles textbooks entails a rent freeze, with perhaps intermittent upward adjustments only partially offsetting inflation. This form of rent control, now termed first-generation rent control, was standard in Europe during the inter-war period and during World War II, and lingered on afterwards, in some jurisdictions persisting into the 1980s. In North America, first-generation rent control was applied during World War II but in all jurisdictions except New York City was dismantled by 1950.

Worldwide, the period immediately following the 1973 Energy Crisis was characterized by high inflation. In jurisdictions that had retained first-generation rent controls, the controls forced rents below market-clearing levels at an increased rate. In both the United States and Canada, many jurisdictions re-introduced rent control, often as one facet of a general wage and price control program. But the form of rent control was milder. While the programs differed significantly from one another, they were often referred to aptly as rent regulation rather than rent control. Now referred to as second-generation rent control programs, they typically allowed rents to be increased annually by a certain percentage automatically (guideline rent increase provisions), and contained supplementary provisions which permitted rents to be further increased on a discretionary basis in response to some combination of cost increases (cost pass-through provisions), cash-flow considerations (financial hardship provisions), and profitability concerns (rate of return provisions). Some programs excluded hous-

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[1] This historical overview echoes Arnott (1995).

ing constructed after the application of controls and luxury housing; other programs contained provisions for the automatic decontrol of units when their rents reached a certain level (rent level decontrol), when the local vacancy rate rose above a certain threshold (vacancy rate decontrol), or when a unit was vacated (vacancy decontrol), or for negotiated decontrol between tenant and landlord.

In the 1970s and 1980s many European jurisdictions replaced first-generation with second-generation rent control programs.

In the post-stagflation era, rent control became a less pressing policy issue. Some jurisdictions retained their rent control programs but due to reduced inflation rates, rents under the guideline rent increase provisions drifted upwards towards their market-clearing levels; in some other jurisdictions, units gradually became decontrolled under the various decontrol provisions; many jurisdictions dismantled rent controls entirely; and finally some jurisdictions changed the form of controls applied.

This evolution has been so varied that it has almost escaped notice that there has been a gradual convergence to yet another form of rent control program whereby *rent increases are controlled within a tenancy but are unrestricted between tenancies*. This class of rent-control programs might be termed third-generation rent controls. But since their defining characteristic is the regulation of rent during but not between tenancies, this class of programs is more descriptively termed *tenancy rent control*.[2]

Lind (1999) and Basu and Emerson (2000) provide partial lists of jurisdictions which currently employ tenancy rent control.[3] These ju-

[2] In some jurisdictions, rent increases between tenancies are controlled but are more generous than within tenancies; whether such programs should be categorized under tenancy rent control is moot.

[3] For documentation of the rent control programs in the jurisdictions listed below, see: Balchin (1996) on Europe; Baar (2002) and City of Santa Monica (2000a,b,c,d) on Santa Monica; Tiatz (1998); Los Angeles Housing Department (2002), "Los Angeles Housing Law" (2002), and Rydell et al. (1981) on Los Angeles; New Jersey Rental Housing Information (2002), Epple (1998), and New Jersey State Senate (1998a,b) on New Jersey; Turner (1988) on Washington, D.C.; Arnott and Johnston (1981), Fallis (1985), Muller (1989), Smith (1988), Tenant Protection Act (1997) and Smith (2002) on Ontario; Borsch-Supan (1996), Hubert (1991b) on Germany; the Delhi Rent Control Acts or 1959 and 1995 for India; and Iwata (2002) on Japan. Comparative studies of alternative rent control programs are provided in Arnott and Mintz (1987), Fraser Institute (1975), Keating et al. (1998), Lind (2000), Olsen (1988), and Turner and Malpezzi (2003).

risdictions are Spain, Switzerland, the province of Ontario in Canada, a number of cities in California, including Los Angeles, Berkeley, Santa Monica, and Palm Springs, a number of jurisdictions in New Jersey, and most major cities in India. Iwata (2002) indicates that Japan currently employs tenancy rent control. There is also a large number of jurisdictions that allow more generous rent increases between tenancies than within tenancies. These include Germany, France, the Netherlands, Washington, D.C., and New York City[4] (for rent-stabilized apartments). Turner and Malpezzi (2003) provides further information.

The purpose of this paper is to explore the economics of tenancy rent control.

The emphasis will be on the positive—investigating the economic effects of tenancy rent control.[5] But the paper will also develop a normative theme: that as a form of rent regulation, tenancy rent control provides a reasonable policy compromise between those who oppose any form of rent regulation and those who favor extensive government intervention in the rental housing market, though the devils—as well as the angels—are very much in the details.

This paper will contrast the market equilibrium under tenancy rent control with the unregulated market equilibrium. This is a somewhat artificial exercise since, to my knowledge, in all those jurisdictions which currently have tenancy rent control, tenancy rent control was preceded by stricter forms of rent control; thus, historically, tenancy rent control has been introduced as a form of partial rent decontrol.

Swedish readers would probably be more interested in a discussion of how the introduction of tenancy rent control would work in Sweden as a way of partially deregulating their rent control system. Unfortunately, I shall have to leave this topic to others more familiar with

[4] The literature on rent control in New York City is vast. References include New York State Division of Housing and Community Renewal (2002), DeSalvo (1971), Glaeser and Luttmer (1996), Gyourko and Linneman (1989), Hochmann (1999), Lowry (1970), Marcuse (1979), Pollakowski (1997), Rapaport (1992), Roistacher (1972), Stegman (1988), Sternlieb (1983), NYC Rent Guidelines Board (2002), New York State Division of Housing and Community Renewal (2002), and The Rent Regulation Reform Act of 1997 (2002).

[5] General theoretical analyses of rent control include Arnott (1995), Basu and Emerson (2000, 2003), Fallis (1988), Fraser Institute (1975), Frankena (1975), Gould and Henry (1967), Hubert (1991a, 1993, 1995, 1996), Igarashi and Arnott (2000), Kutty (1996), Marks (1984), Miron and Cullingworth (1983), and Olsen (1990, 1998).

the current system of rent control in Sweden. Hopefully, however, the current paper will provide some clues.

Section 2 will provide a broad, non-technical discussion of both the positive and the normative aspects of tenancy rent control. Section 3 will provide a policy evaluation of tenancy rent control. And section 4 will conclude.

2. Positive and normative effects

This section will provide a casual and common-sense discussion of the economics of tenancy rent control. The first subsection will look at tenancy rent control from the landlord's perspective; the second will do the same, but from the tenant's perspective; the third will put the two sides of the market together and analyze the effects of tenancy rent control on the operation of the market, and the fourth will discuss the welfare economics of tenancy rent control.

2.1. The landlord's perspective

Consider a landlord operating under tenancy rent control. If the rent control is binding, he will realize that it will force the rent he can charge increasingly below the rent he would charge in the absence of controls (which will subsequently be termed the free market rent) the longer a tenant remains in a unit. The rational landlord will respond in four obvious ways.

First, he will "front-end-load" the rent; he will set the initial rent above what he would charge in the absence of controls in an attempt to compensate for the "loss" (relative to the free market rent) he will make on his unit in the later years of a tenancy. In a competitive market, landlords make zero expected economic profits. Thus, the landlord will set the initial rent such that on average the discounted "profit" he makes during the initial years of a tenancy will exactly offset the loss he makes in the later years. In other words, tenancy rent control will tilt the nominal rent profile—the time path of rents—during a tenancy, making it flatter than it would be in the absence of controls.

Second, since the landlord makes profits during the early years of a tenancy and losses during later years, he has an incentive to choose tenants who, on the basis of their income-demographic characteristics, are likely to be short-term. Thus, if he has more than one applicant for a vacant unit, he will tend to choose a student or young sin-

gle, who has not yet put down roots, rather than a married couple with children or a widow.

Third, since his expected discounted profits from a unit are lower the longer a tenant remains in a unit, he has an incentive to speed up the tenant's departure. Landlords differ in their degree of scrupulousness. Some will consider it a point of honor to be responsible, and so will act according to the terms of the lease, responding to tenants' complaints and undertaking repairs promptly, and will demonstrate some flexibility with respect to tenants whose temporary financial difficulties are causing them to occasionally be late in their rent payments. But other landlords will be opportunistic, deliberately ignoring tenants' complaints, dragging their feet on repairs, and undertaking needed improvements such as upgrading appliances and painting only between tenancies, as well as hard-nosed, initiating eviction proceedings upon the slightest infraction by the tenant of the terms of the lease—late payment by a day or a single complaint by another tenant of noise or other anti-social behavior.

Fourth, since the rent at which he initially leases the unit will largely determine the time profile of rents he can charge throughout the tenancy, the landlord has a strong incentive to set the initial rent "as high as the market will bear". He can achieve this in two ways. He will invest in ways that make the unit "show well"; when a tenant vacates the unit, he will repaint it, replace the carpeting, undertake repairs, update appliances, and perhaps modernize the bathroom and the kitchen; his incentive to maintain the unit *during* a tenancy is correspondingly reduced. He will also have an incentive to hold out for a tenant who really likes the unit and is willing to pay a premium to rent it (whose idiosyncratic tastes mesh well with the idiosyncratic features of the unit).

2.2. The tenant's perspective

Consider a prospective tenant under tenancy rent control. If the rent control is binding, she will realize that the longer she stays in a unit, the lower her real rent will be. This will provide her with an incentive to stay in her current unit for longer than she would in the absence of controls; that is, tenancy rent control has a lock-in effect. If her tastes, her income or her demographic status change, she may decide to stay put in her current unit, even though it is no longer quite what she wants or needs, because the rent is significantly lower than that she would pay for housing of comparable quality were she to move. If she

changes jobs, she may decide to hang on to her current unit rather than move to one closer to her new job, even though this means a substantial increase in her commuting costs. In other words, she is willing to suffer increased housing mismatch costs in order to benefit from the reduced rent on her current unit. She may also turn down a better job elsewhere in the metropolitan area or in another city in order to take advantage of the cheap rent on her current unit, which results in increased job mismatch costs. She may also illegally sublet her unit, either to make a profit by charging above the controlled rent or to keep open the option of returning to live in it at its substantially below-market rent at some point in the future. Since she will realize that tenancy rent control will give her an incentive to stay in her unit longer than she otherwise would, she has an incentive to spend more time searching for a unit. Not only will her search costs be amortized over a longer period of time, but also she will realize that she should choose a unit that suits not only her current circumstances but also her probable circumstances several years down the road.

After she moves in to her new unit, she will likely find that her landlord is less attentive to the maintenance of her unit than he would be in a free market and also that he is unresponsive to her requests to make improvements—to upgrade her appliances, to replace the carpet that has become stained and tattered, or to repaint. As a result, she will likely find herself undertaking much of the maintenance on the apartment, and also making improvements on her own, probably with the landlord's approval but without his financial assistance.

Being evicted will be more costly than it would be in a free market. Since she will have to pay the entry rent on any apartment she moves to rather than the reduced rent on her current unit, the costs she will suffer upon eviction are not only the direct moving costs but also the present value of the increased rent she will have to pay on the new apartment. She will also realize that the landlord has a stronger incentive to evict her than he would in a free market. For both these reasons, she will take greater care than she otherwise would to avoid eviction. She will make sure she has the funds in her account to pay for next month's rent on time, and she will be a more responsible tenant, strictly observing the terms of her lease with respect to visitors, noise, trash disposal, pets, and so on.

Economists tend to slight the importance tenants attach to *security of tenure*. A housing unit is a tenant's home. Coming to know her neighbors and the local shops, she will develop at least some sense of

community. As well, she will value the sense of permanence and stability provided by a home in which she feels secure. *A priori* tenancy rent control has offsetting effects on security of tenure. On one hand, it will lead to stricter enforcement of leases and increased eviction costs. On the other, it will provide insurance against "economic eviction"—having to move because local rents have risen beyond what she can afford, due to a boom in the local housing market. Most tenants would consider that having to behave more responsibly so as to adhere to the terms of the lease is a fair price to pay for insurance against economic eviction. In fact, the introduction of rent control is almost always accompanied by changes to landlord-tenant law that are favorable to the tenant. Consequently, the introduction of tenancy rent control will almost certainly improve security of tenure.

2.3. Operation of the rental housing market

Taking into account how tenancy rent control affects the behavior of landlords and tenants, it is possible to infer how tenancy rent control will affect the operation of the housing market. The discussion is organized into the effects on conversion, new rental housing construction, choice of tenure status, rents, maintenance, tenancy duration, search costs and vacancy rates, mismatch costs, distribution, and security of tenure. It will also treat partial coverage tenancy rent control and the politics of tenancy rent control.

Conversion

"Conversion" is a generic term relating to changes in the status of housing units with no change in the external structure of a building. Downward conversion refers to the division of a larger housing unit into smaller units, and upward conversion the reverse. Rehabilitation is another form of conversion, as is a change in the tenure status of a unit from tenancy to owner-occupancy. While piecemeal conversion of individual units within a building is possible, it is typically considerably more costly than the simultaneous conversion of all units. Landlord-tenant law differs across jurisdictions with respect to conditions under which tenants may be evicted to accommodate a landlord's desire to convert his building to a presumably more profitable use. But whatever the landlord-tenant law, the introduction of tenancy rent control will increase tenant resistance to "conversion eviction", which will make conversion more costly and difficult. Constraining

landlords' ability to exploit profit opportunities requires rents to rise in order to continue satisfying the zero profit condition.

Construction and tenure status

The introduction of tenancy rent control has no obviously strong effect on the incentives to undertake rental housing construction. The rental tilt will increases profits in the early years of a tenancy, with offsetting decreases in later years. And the discouragement of conversion will be offset by a rise in the level of market rents. Since tenants will on average stay in their apartments longer and in many cases occupy only one unit prior to buying a starter home or condominium, the average age at which they make their apartment choices will be lowered. Particularly if tenants are liquidity constrained at the time they choose their rental housing units, this may lead to increased demand for smaller units and decreased demand for larger units. Iwata (2002) argues that the small average size of rental compared to owner-occupied units in Japan is attributable to this effect. Probably all these effects will be dominated by how the introduction of tenancy rent control affects landlords' expectations concerning the future regulatory environment of the housing market, which will depend on the political situation that lead to controls being applied. Landlords might view the introduction of tenancy rent control as the "thin edge of the wedge", as presaging a future regulatory environment that is more pro-tenant and anti-landlord and perhaps the application of stricter forms of rent control in the future. This would cause landlords to cut back on rental housing construction, and uncertainty about the future would lead them to postpone construction.

The effect of tenancy rent control on the prevalence of renting versus owner-occupancy is not obvious either. On one hand, any constraints on landlords' maintenance and conversion activities are likely to drive up the market-clearing rent, leading to demand substitution towards other goods, most notably owner-occupied housing. Furthermore, to avoid the hassles, uncertainty, and reduced flexibility which any form of rent control give rise to, builders may decide to put their new units on the market as condominiums rather than rental units. On the other hand, since the typical household's life cycle entails tenancy followed by owner-occupancy, tenancy rent control by encouraging longer tenancy duration, may induce households to delay the purchase of their starter home. Also, the application of rent control typically leads to restrictions on the conversion of rental units to

condominiums, though whether this applies with tenancy rent control is unclear

Maintenance, improvements, rehabilitation, and reconstruction

As noted earlier, tenancy rent control provides landlords with the incentive to undermaintain and to undertake improvements between rather than within tenancies. These effects are mitigated if the tenancy rent control program contains cost pass-through provisions, which permit rents to be raised during a tenancy above the guideline rent increase in response to cost increases and expenditure on improvements. While tenancy rent control would change the timing of maintenance and improvements, it would be unlikely to have a strong effect on their average levels.

Since rehabilitation usually entails major alternations to the entire interior of a building—changing the plumbing and electrical systems, and even gutting the building—it is usually undertaken with no sitting tenants. In the absence of rent control, the landlord can achieve this simply by not renewing annual leases. But tenancy rent control almost invariably comes with restrictions on conversion, since otherwise a landlord could get rid of long-term tenants paying substantially below-market rents by rehabilitating. Thus, tenancy rent control is likely to have a strong negative impact on the amount of rehabilitation. A similar argument applies with respect to demolition and reconstruction. By making rehabilitation more difficult, tenancy rent control is likely to cause more rapid deterioration of the rental housing stock than would occur in a free market, and by making reconstruction more difficult, is likely to reduce the volume of construction in built-up areas of cities.

Tenancy duration

Unless landlords are successful in discouraging long-term tenants from staying, which seems unlikely, average tenancy duration should increase under tenancy rent control. Hard evidence is hard to come by, however.[6]

[6] Rapaport (1992) found no significant difference between free-market and rent-stabilized (which are subject to regulation akin to tenancy rent control) apartments in New York City in the tenant exit rate. Even if she had found a difference, it could be due to selection effects as well as to tenancy rent control leading to longer tenancies; since rent-stabilized apartments have front-end-loaded rents and lower

Search and mismatch costs

As noted earlier, under tenancy rent control landlords have a stronger incentive to wait for a tenant who is willing to pay a premium for a unit that suits her tastes very well and who is unlikely to remain in the unit for long. Prospective tenants too have an incentive to search more intensively than they would in a free market since they will anticipate longer tenancy durations. Operating contrary to these two effects, tenancy durations will be longer so that search will be less frequent. The overall effect on the vacancy rate is ambiguous. So too is the effect of tenancy rent control on average mismatch costs. On one hand, prospective tenants search more intensively; on the other, tenants are more likely to stay in a controlled apartment which is no longer well-suited to their needs and may have deteriorated significantly over the tenancy.

To the extent that tenancy rent control discourages rental households from accepting better job opportunities because doing so would require them to give up the benefits of their reduced rent, it will adversely affect the functioning of the labor market.

Distributional effects

The man on the street views rent control as favoring the tenant and hurting the landlord. The actual distributional effects of rent control programs are more complicated. If the rental housing market is perfectly competitive, land and housing values will continuously adjust so that landlords make the competitive rate of return. The persons who are hurt by the (unanticipated) application of controls are the owners of buildings and land at the time the controls are applied. They suffer a windfall loss equal to the present value of the fall in rents net of costs over the entire period during which it is anticipated that controls will be applied. Tenants as a group typically benefit from rent control during the early years of its application, but as time proceeds the efficiency loss associated with controls may become so large that rent control hurts them as well. There may also be substantial distributional effects between different types of tenants. Under classic rent control programs, long-term tenants benefit at the expense of prospective tenants; the long-term tenants have ample housing at substantially below-market rents, while prospective tenants will suffer in

vacancy rates (search for them therefore entailing higher costs) they are likely to attract tenants who anticipate longer tenancy durations.

their search from low vacancy rates and may have to settle for a run-down unit that does not suit their needs well. Classic rent control programs also generate excess demand, which results in housing being rationed. The rational landlord will choose easy tenants, childless couples and the elderly, and avoid difficult tenants, students and couples with young children. He can also discriminate with no penalty.

Tenancy rent control too may cause substantial redistribution between groups, but the winners and losers are different. Tenancy rent control causes no excess demand since entry rents are completely free. Because of the front-end loading of rents during a tenancy, less mobile tenants benefit from the application of controls at the expense of more mobile tenants; this effect is partially offset to the extent that, when selecting tenants, landlords favor more mobile households. Thus, the tenants who benefit the most are less mobile households from more mobile groups, and those who are hurt the most are more mobile households from less mobile groups. Landlords as a group lose from the application of tenancy rent control since it imposes a constraint on their profit-maximizing programs and since it introduces the spectre of more stringent controls in the future. As will be discussed later, rent control is almost invariably accompanied by improved security of tenure. Most likely this benefits tenants at the expense of landlords, though it is important to recognize that tenants pay for improved security for tenure through higher rents.

Partial coverage tenancy rent control

Partial coverage rent control may take two general forms. In one, some but not all rental units are covered by controls; for example, luxury apartments or apartments constructed since the application of controls may be exempt. Under tenancy rent control, this form of partial coverage will make it easier for those who would have difficulty finding a controlled unit to obtain suitable rental housing. But since landlords in the uncontrolled portion of the rental sector may fear that controls will later be applied to their units, they may charge more than they would in the absence of controls. In the other form of partial coverage rent controls, controls are applied in some jurisdictions within an area, but not others, which induces sorting. Under tenancy rent control, there are offsetting effects. Landlords in controlled jurisdictions will favor high-mobility tenants, but high-mobility tenants will prefer to rent in the uncontrolled jurisdictions where they

will pay market rents rather than the above-market rents of the early years of a tenancy under tenancy rent control.

Security of tenure

As noted earlier, *a priori* the effects of tenancy rent control on security of tenure are ambiguous; tenancy rent control provides tenants with insurance against sharp rent increases, but also provides landlords with a stronger incentive to evict. In fact, however, rent control programs usually contain provisions which improve security of tenure. This may be because rent control is normally introduced when the balance of political power favors tenants, or because legislators realize that rent control can be significantly undermined unless security of tenure provisions are strengthened. In the case of tenancy rent control, landlords can undermine the controls if permitted to evict tenants due to minor lease infractions or in order to rehabilitate their units or to rent to relatives.

Politics[7]

Classic, first-generation rent control programs had obvious and severe detrimental effects on the housing market. They were retained in many jurisdictions long after the reasons for their initial imposition had passed because of the opposition of sitting tenants to their removal. Second-generation rent control programs have been more flexible and less biting, but the longer they have been applied the greater and more obvious their adverse effects on the housing market. Ontario's post-1975 experience with rent control is an example (see Smith, 1988). The second-generation program put in place in 1975 was relatively flexible and mild, but controlled rents between tenancies as well as within tenancies. In the early years of its application, the effects appeared to be quite modest, but gradually vacancy rates fell to alarmingly low levels, which signaled that continued application of the program would seriously harm the rental housing market. As a result, Ontario switched to tenancy rent control, though there has recently been political pressure for reversion to stricter controls (Smith, 2003).

Tenancy rent control is different. Because rents are free to vary between tenancies, tenancy rent control will not have an *increasingly* ad-

[7] Works on the political economy of rent control include Epple (1998), Fallis (1988), Keating et al. (1998), and Turner (1988).

verse effect on the rental housing market. The housing market will not function less and less well, until eventually it becomes obvious that the continued application of controls is untenable or at least extremely costly. Rather, under tenancy rent control the housing market will move to a new equilibrium which, according to conventional reasoning, will be less efficient than the free-market equilibrium, but the *efficiency losses will be relatively small, and will remain steady and not grow exponentially*. For this reason, tenancy rent controls are relatively easy to live with. Landlords will oppose them to be sure but their removal will not be a matter of urgent concern, especially since the costs associated with their application will have been suffered mostly by rental housing owners at the time controls were applied, in the form of capital losses. Competitive landlords will continue to get the market rate of return. They will be unhappy with the increased difficulty of evicting problem tenants, but may view this as a problem associated with the landlord-tenant law rather than with tenancy rent control per se. Since long-term residents of a jurisdiction are typically disproportionately powerful politically and since long-term tenants are the big winners from tenancy rent control, the tenant lobby will strongly favor the retention of controls. Thus, it can confidently be predicted that, once in place, tenancy rent control will be politically difficult to remove.[8] If landlords realize this, they will strongly oppose a supposedly temporary introduction of tenancy rent control, and if tenants realize this, they will strongly support the policy.

2.4. The welfare economics of tenancy rent control

One of the central results of modern microeconomics is that a perfectly competitive economy is efficient, and hence that any government intervention that impacts economic decisions at the margin is inefficient (lump-sum redistribution is acceptable since it does not generate inefficiency-inducing substitution effects). That actual economies do not conform to the strict requirements of perfect competition has long been recognized. Even the most dyed-in-the-wool Chicago economist feels no discomfort in acknowledging the classic market failures—increasing returns to scale, public goods, and externalities—and the potential benefit of government intervention to correct these market failures (though he may argue that the efficiency costs that government intervention would entail would be larger than

[8] A similar point is made in Fallis (1988).

the efficiency costs associated with the market failures). But none of the classic market failures is central in the housing market. From this classic perspective, which is the mainstream perspective among US economists at least, government intervention in the housing market is not warranted. It is on the basis of this line of reasoning that the vast majority of economists have opposed any form of rent control, and the large majority continue to do so.

The asymmetric information revolution has made economists aware that the conditions for perfect competition are considerably more stringent than was recognized by the classical welfare economics that prevailed from Marshall up into the seventies. Transactions costs are very important; in only a few markets are products homogeneous; almost all economic exchange involves asymmetric information; and markets are seriously incomplete. Furthermore, the theory of the second best has taught us that an imperfection in one market can be mitigated by offsetting intervention in some other market—two small deadweight loss triangles are smaller than one large one. Thus, we are now in a situation where a *prima facie* plausible case can be made that just about any form of government intervention is potentially beneficial.

While the asymmetric information revolution has strengthened arguments in favor of government intervention in almost all areas of public policy, it has also stimulated counter-arguments. One line of counter-argument has been that governments suffer from their own failures: decisions are made more on the basis of pressure from interest groups than of benevolent concern; bureaucratic incentives are weak; and in some countries at least, the power of government is used to line the pockets of corrupt politicians and bureaucrats. The demonstrated success of the deregulation spearheaded by Margaret Thatcher and Ronald Reagan has provided empirical support for these counter-arguments.

Despite the strength of these cross-currents, there does seem to be a dominant view among mainstream economists concerning the appropriate scope of government intervention. Whether or not government intervention is desirable in a particular policy context should be decided on a case-by-case basis and not on ideological grounds. Furthermore, since economically sound arguments can be made on both sides of almost any public policy debate, decisions should be based on a quantitative assessment of the proposed policy's costs and benefits. And where there is considerable uncertainty about the pol-

icy's costs and benefits, or where the costs and benefits appear more or less evenly balanced, the market should be favored. Put alternatively, the burden of proof should rest with those who favor government intervention, and the market should be the default option.

The above paragraphs relate to *efficiency* arguments for and against government intervention. The situation is more complicated with respect to equity arguments. According to classic welfare economics, the economist should focus on efficiency. It is quite acceptable for the economist to analyze the distributional effects of a policy. But since equity is an ethical and metaphysical concern, and therefore not amenable to scientific analysis, it is up to the policy-maker not the economist to weigh equity against efficiency. Furthermore, where equity objectives are to be pursued, they should be pursued in the most efficient way, which entails lump-sum redistribution. The literature on the optimal income tax has made it clear that this neat separation between equity and efficiency is untenable. Individuals have private information relevant to how much subsidy they merit from the government. To redistribute equitably, the government could ask individuals how much they deserve but should not expect completely honest answers. As a result, government will base its redistribution on observable individual characteristics that are correlated with need. Some of these observable characteristics are intrinsic but most are not, and the individual has an incentive to change his behavior in a way that makes him appear more needy. The central example is the income tax. Individuals make themselves appear more needy by cutting back on how much they work thereby lowering their incomes, which entails distortion. Realistic programs of redistribution therefore induce inefficiency.

This argument is now broadly acknowledged. But there is no general agreement among economists concerning its implications for how best to achieve equity. One group argues that equity objectives should be achieved exclusively with an optimal income tax. Another holds that both optimal income taxation and optimal commodity taxation should be employed, with commodity taxation being employed to reduce the deadweight loss associated with the labor-leisure distortion induced by the income tax, which is achieved by taxing complements to leisure and subsidizing substitutes. Yet another holds that need is more complicated than simply income-earning potential, entailing in addition physical and mental health status, both of which have many imperfect correlates on the basis of which redistribution could be ef-

fected. For example, it is frequently argued that unemployment insurance should be a redistributive program rather than a pure insurance program, since after controlling for income the status of being unemployed is partially correlated with poor mental health and hence need. And yet another group sees the income tax as the outcome of a political process involving competing interest groups, rather than a program optimally designed to achieve equity, and hence views equity considerations as a central element of all public policies. A middle-of-the-road economist is willing to entertain equity arguments in almost any public policy context, but to favor equity considerations being weighed heavily in the design of a particular public policy needs to persuaded that a particular policy instrument is an efficient tool for redistribution.[9]

In an earlier paper, Arnott (1995), I put forward the argument that a well-designed second-generation rent control program can be welfare-improving. The argument was based exclusively on efficiency considerations. The centerpiece of the argument was that, because housing is such a strongly differentiated commodity and because tastes for housing are so idiosyncratic, the housing market is monopolistically competitive rather than perfectly competitive. This causes, rents to be above efficient levels, and the corresponding deadweight loss can be reduced with moderate rent control. Another argument put forward in that article was that rent control counteracts excessive eviction. Because eviction entails substantial social cost and merely succeeds in transferring a bad tenant from one unlucky landlord to another, it entails a negative externality. Since rent control tends to go hand-in-hand with greater tenant rights and in particular with greater difficulty of eviction,[10] it reduces the deadweight loss associated with this externality. (A counter-argument is that being a bad tenant is not exogenous; harsh eviction laws are needed to give inconsiderate and irresponsible tenants the incentive to behave in a more socially responsible manner.) Yet another argument was that rent control is an effective way of reducing the disruption that would be caused by a

[9] Economists are trained to respect individual choice/consumer sovereignty and accordingly tend to be *general egalitarians*. Non-economists tend to be *specific egalitarians*, viewing the consumption of some goods—including notably housing—as more meritorious than the consumption of others.

[10] In the absence of rent control, policies which attempt to make eviction more difficult are unlikely to be effective since the landlord can simply economically evict the tenant by raising her rent.

temporary and rapid increase in rents. There are also potentially many arguments along the lines that rent control can mitigate distortions associated with imperfections in the housing market, but the above three are especially persuasive since in each rent control directly addresses the corresponding distortion and it is a general rule of thumb that mitigation of a distortion is most efficiently achieved by those policy instruments which counteract it most directly.

I have never been persuaded that rent control is an efficient policy for redistribution. Subsidizing the poor's housing can be justified on several grounds: housing as a merit good, specific egalitarianism, and children's welfare. But rent control's target efficiency is low; housing allowance programs are superior if the goal is to provide affordable housing for the poor. Also, achieving reduced rents by expropriation from landlords is hard to justify on any reasonable equity grounds.

While my article was widely interpreted as supporting second-generation rent control, that was not my intention. The message I had hoped to convey was that a well-designed rent control program can be beneficial, and hence that blind opposition to all rent control programs is unsound. I am quite willing to concede that many and indeed most second-generation rent control programs, and probably all first-generation rent control programs, have been on balance harmful, especially when account is taken of the political difficulty of removing rent controls when they are only temporarily justified.

Among rent control programs tenancy rent control has some particularly attractive features. While I remain on the fence concerning the overall desirability of tenancy rent control, I believe that if rent controls are to be instituted they should permit rent to be increased without restriction between tenancies. The argument is developed in the next section.

3. Policy argument

This section will argue that the desirability of tenancy rent control boils down to weighing its efficiency costs against the net benefit from the improved security of tenure it provides.

3.1. Efficiency costs of tenancy rent control

Almost all first-generation rent control programs were instituted during war time to prevent profiteering on housing, and were successful in achieving this limited goal. The politics of rent control however

resulted in their being retained in many jurisdictions long after this goal was relevant. As generations of economists have stressed, the rationale underlying the application of first-generation rent controls in peace time (at least after reconstruction) is fundamentally misguided. Rental housing is certainly made more affordable by regulating its consumer price to be below the market level, but rent controls force down the producer price as well. Supply contracts, and the resulting excess demand is dealt with through rationing. As pointed out by Glaeser and Luttmer (1996), rationing creates not only the familiar deadweight loss triangle but additional deadweight loss due to the good not being allocated to those who value it most. Additional sources of deadweight loss arising from price controls include increased search costs and discrimination in the allocation of the good. In the case of housing, because of its durability, rent control discourages mobility, which results in households being increasingly mismatched with units, and adversely impacts the allocation of workers over jobs. As time proceeds, rents fall increasingly below market-clearing rents and, since deadweight losses tend to rise as the square of the magnitude of the distortion, efficiency costs rise quadratically. To combat the deteriorating state of the housing market, governments intervene by supplying and allocating housing themselves, and by turning a blind eye to key money arrangements—which compound the lock-in effect of controls—and perhaps eventually legalizing them. In those jurisdictions where government intervention is strong, the rental housing market withers away and comes to be replaced by a government-controlled rental housing sector in which housing is allocated administratively rather than through the market. All this is familiar, and accounts for economists' almost-unanimous opposition to traditional rent controls.

Those second-generation rent control programs that control rents between as well as within tenancies have been less harmful and in some cases perhaps even benign. Some programs have been sufficiently mild and have incorporated enough safety valves—in the form of cost-pass-through, rate-of-return, and hardship provisions, and exempted housing—that the housing market has not got severely out of kilter. Other programs however have induced the downward spiral in market performance characteristic of first-generation controls, albeit at a slower rate. But even in those jurisdictions in which the programs have been relatively mild, there is always the worry that the

politics of rent control will lead to the programs being hardened, with the concomitant cumulative deterioration in market performance.

The big advantage of tenancy rent control is that it provides a safety valve—unrestricted rent increases between tenancies—that ensures that the performance of the housing market will not get progressively worse. Rather, tenancy rent control will lead to the establishment of a different long-run equilibrium. Furthermore, the politics of tenancy rent control make it unlikely that elimination of the provision permitting unrestricted rent increases between tenancies will gain majority support. The reason is simply that most rent control programs are local, and the powerful players in local politics are long-term residents. Long-term homeowners are concerned about the property value of their housing, which may be hurt by eliminating the provision, and long-term tenants, enjoying below-market rents in a well-functioning housing market, have good reason to favor the status quo. For the same reasons, however, there is unlikely to be much momentum generated for the removal of tenancy rent control.

That tenancy rent control is safer than other forms of rent control does not of course establish its desirability. Most economists believe that the best rent control is no rent control. To determine whether tenancy rent control is on balance desirable, it is necessary to compare the equilibrium with tenancy rent control with the unregulated market equilibrium. Since each has its good and bad points, *a priori* argumentation cannot establish which is superior. Instead, an assessment is needed which quantifies the relative costs and benefits. Unfortunately, the current empirical literature provides little guidance.

Most of the sound empirical work on rent control has been on the New York City program. Because the New York City experience is so idiosyncratic, it is very much open to question whether the empirical regularities uncovered in that literature cast much light on the likely effects of introducing tenancy rent control in jurisdictions with no prior experience with controls. Controls have been in place in New York City for over sixty years, and have gone through a myriad of transformations, from a classic, first-generation program to the current system with three categories of rental housing (rent-controlled, rent-stabilized, and free market) each with its own set of regulations. Furthermore, rent-stabilized housing is subject to only "partial" tenancy rent control; rent increases between tenancies are regulated but are more generous than rent increases within tenancies. The same caution needs to be applied in interpreting the results of non-North-

American rent control studies; while some of these jurisdictions currently have tenancy rent control, the current state of their housing stock is likely to have been heavily influenced by their past experience with harder controls.

The rent control experience of other North American jurisdictions that currently have tenancy rent control is more relevant since these programs have a considerably shorter history and have never been as severe. Unfortunately, there have been few expert studies of the effects of tenancy rent control in these jurisdictions. Even if expert studies were undertaken, there would be formidable econometric difficulties in isolating the effects of controls. Since most of these programs have been mild, it would be difficult to filter out the weak rent control signal from all the background noise. Also, because in North America having a rent control program in place is a local (or state or provincial) choice, selection problems would be severe too; factors X might jointly have influenced both which jurisdictions have adopted rent control and how the housing markets in those jurisdictions have performed, independent of the effects of rent control *per se*. Finally, since almost all the rent control programs are local, with some jurisdictions within a metropolitan area having them and some not, and with those jurisdictions having them differing one from another in the details of their programs, sorting phenomena are potentially important; for example, households anticipating a long tenancy would be attracted to the rent-controlled jurisdictions.

As a theorist, I may be excessively demanding in my standards for what constitutes persuasive empirical evidence, but my judgment is that the existing empirical literature on rent control provides little useful information concerning the effects of tenancy rent control programs. *A priori* reasoning is by its nature qualitative. The empirical work that has been done is not very informative. How therefore should the desirability of tenancy rent control be evaluated? With the rapid diffusion of econometric competence, it is only a matter of time before good econometric studies are done on tenancy rent control. In the interim, however, simulation models and even crude back-of-the-envelope calculations are probably the best that can be done.

Though it does not threaten the viability of the housing market, tenancy rent control does generate distortions. It gives landlords the incentive to undermaintain during a tenancy and to undertake most improvements between tenancies; in conjunction with changes in landlord-tenant law that typically accompany it, it makes rehabilitation

and reconstruction more difficult; and it has a lock-in effect which reduces not only housing mobility but also labor mobility and may increase mismatch costs. It may also be judged unfair in favoring long-term tenants at the expense of short-term tenants and newcomers to a jurisdiction, though this is partially offset by its giving landlords the incentive to favor short-term tenants in the tenant selection process. Estimates of the deadweight loss associated with these various distortions have not been made.

3.2. The net benefits from improved security of tenure

The cost of these distortions must be weighed against the benefits of tenancy rent control. Market imperfections abound, and are likely particularly severe in the housing market. Tenancy rent control may offset the distortions generated by some of these imperfections, but may also compound others. Overall, I find only one second-best argument in favor of tenancy rent control compelling—that related to security of tenure.

Almost all economists lead financially secure lives and were raised by parents who emphasized responsibility and self-discipline. They have little or no personal experience with the insecurity that is ever-present in the lives of the less advantaged—those from dysfunctional families, those not raised to middle-class values, and the less able—who tend to live from one paycheck to the next. Not surprisingly, therefore, most economists ignore or underemphasize the importance of security of tenure in rental housing, even though it is consistently second only to affordability on the list of concerns raised by tenant groups.

Security of tenure is a set of tenancy property rights specifying that the tenant be subject to eviction under only a restricted set of circumstances. Where security of tenure provisions are specified in law rather than being subject to contractual negotiation, typically eviction is permitted only for serious delinquency in rent payment or for disruption to neighbors.

In a celebrated article published in 1963, Arrow (1963) put forward the view that many social institutions arise to take the place of missing markets. Contracts are one such institution. Security of tenure is usefully regarded as a set of provisions in the landlord-tenant contract which provide the tenant with implicit insurance against a number of types of housing-related risk for which market insurance is unavailable. Two types of risk are of primary importance: rent risk and con-

version risk. Rent risk derives from uncertainty concerning the future time path of market rents, and conversion risk from uncertainty concerning the profitability of future conversion opportunities available to the landlord.

A conservative economist would argue that gains from trade should be exhausted under unrestricted freedom to contract, in this context that an individual tenant and an individual landlord should negotiate a landlord-tenant contract that is optimal for them. There are difficulties with this argument. Because of transactions costs, it is excessively costly for a single landlord and an individual tenant to negotiate all the terms of the landlord-tenant contract; as a result, there is typically a standardized lease to which the individual landlord and the individual tenant negotiate adjustments. Also, because of the varied contingencies that may arise, many of which cannot be foreseen at the time the contract is signed, contracts are incomplete. The law and legal precedent provide the basis for determining landlord and tenant obligations under contingencies not specified in the lease. Landlords are typically considerably better informed concerning the terms of the law and how that law has been interpreted by the courts, which gives them a considerable advantage in contract negotiation. In addition, there is a suite of potential contractual failures that stem from asymmetric information. Particularly important are adverse selection effects. A tenant who is keen to have liberal provisions for late payment of rent in the contract likely anticipates difficulties in paying rent. Similarly, a landlord who is resistant to including guarantees that he will not decline to renew the lease in order to convert, probably has intentions to convert. Consequently, both landlord and tenant will be wary in negotiating adjustments to the standard lease. Exactly what form the standardized lease will take and what form of adjustments will be routinely negotiated will vary from place to place, depending on among other things the landlord-tenant law and the corresponding case history. The typical outcome, at least in larger buildings, seems to be that the lease is as pro-landlord as is permissible under the landlord-tenant law and provides the tenant will little or no opportunity for negotiation; for example, in North America the standard term of the lease is one year and cannot be negotiated.

The above argument strongly suggests that leases generated by negotiation between the individual tenant and the individual landlord would favor the landlord's interests and not be efficient, and further-

more that landlord-tenant law is needed to protect tenant's interests and in particular to ensure security of tenure.

The question then is what protections landlord-tenant law should provide tenants. Let us consider the two primary risks faced by the tenant which were mentioned earlier—conversion risk and rent risk. Anas and Arnott (2002) addresses the issues related to conversion risk. If the tenant wants to stay in her unit at the prevailing market rent and if the landlord wants her to leave in order to convert the apartment to a more profitable use, there is a clear conflict. Whose interests should prevail?

Anas and Arnott consider this question under risk neutrality, though their analysis could be extended to treat risk aversion. They argue that the issue is primarily one of efficiency, and that what constitutes the efficient outcome is essentially an empirical issue. If tenants tend to have only a weak attachment to their particular units and have low moving costs, and if the average profit to be made from conversion is high, as it probably would be in a housing market with considerable income and population growth, giving eviction rights to landlords is efficient. If, alternatively, tenants tend to develop strong attachments to their particular units and have high moving costs, and if conversions have relatively low profit margins, as would likely be the case in stagnant housing markets, providing tenants with protection against "conversion eviction" is desirable.

Rent risk derives from changes in costs and changes in demand. Consider first the rent risk stemming from changes in costs. A free market determines that cost changes, whether anticipated or unanticipated, are shared between landlords and tenants on the basis of aggregate supply and demand elasticities. How should they be shared if instead rents are regulated? Contract theory indicates that risk aversion, moral hazard, and access to credit markets are all potentially important. The theory of economic justice, in contrast, would place fairness at center stage. Suppose, for the sake of argument, that the criterion of fairness employed is the avoidance of hardship. How cost increases are dealt with then matters more than how cost decreases are treated. If labor costs rise, the landlord can avoid hardship (cash flow problems) by cutting back on maintenance and improvements. But the landlord has little flexibility in responding to increases in utility costs and even less in responding to increases in mortgage interest rates. At the same time, the tenant can respond to labor cost increases by undertaking more maintenance herself without undue hardship,

but if her rent is increased due to increases in utility costs and mortgage rates, she may face economic eviction. Another consideration is that it should be easier for landlords to avoid cash flow problems through prudent financial management than it is for at least poor tenants to avoid financial distress due to a rent increase. Fairness suggests therefore that cost increases should be shared between tenant and landlord, with the landlord bearing the larger share. By symmetry, therefore, fairness calls for the landlord to enjoy the lion's share of cost decreases.

Consider now changes in demand. Here fairness provides clearer guidance. If the rent for sitting tenants is raised in response to an increase in demand, landlords will benefit and some tenants will suffer hardship due to economic eviction. Hardship is avoided by holding the rent for sitting tenants steady. Under tenancy rent control, landlords still benefit from the increase in demand through the increase in the entry rent for new tenants. This exacerbates affordability problems but does not compromise security of tenure. Thus, landlords essentially subsidize the rents of sitting tenants out of the windfall gains they make from the increase in the entry rent, which seems fair. By symmetry, rents for sitting tenants should be held steady when demand falls.

This notion of fairness, defined as the avoidance of hardship, therefore provides a rationale for the treatment of rents under tenancy rent control and more generally for security of tenure provisions in landlord-tenant legislation. Conventional contract theory typically comes up with the result that what is optimal "all depends on parameter values". Thus, while an argument for tenancy rent control and for security of tenure provisions may be made based on conventional contract theory, the argument would hold in some situations and not in others.

The above line of reasoning presents a case based on fairness for landlord-tenant law to contain provisions protecting tenants against rent risk, and a weaker one based on efficiency that under some circumstances landlord-tenant law should protect tenants against conversion risk as well. That landlords can circumvent the provisions protecting tenants against rent risk by conversion strengthens the argument for including tenant protection against conversion risk in the security of tenure provisions of landlord-tenant law.

There are two potentially potent arguments against landlord-contract law providing strong security of tenure. The first has been

mentioned already – that in a growing housing market, conversion restriction can be very costly in terms of profitable conversion opportunities foregone. The second is that strong security of tenure shields the bad tenant.

There is a significant minority of bad tenants. Bad tenants come in two varieties. There are those who are extremely antisocial—loud music at all hours, raucous parties, violent domestic disputes, extreme uncleanliness, and threatening and criminal behavior; such tenants can make life miserable for their neighbors. And then there are those who are completely opportunistic, deliberately not paying rent and then dragging eviction proceedings out to the full duration of time permitted under the landlord-tenant law. Both types of tenants are a nightmare for their landlords. Strong security of tenure typically comes with provisions that make eviction a long, drawn-out procedure and therefore abets the bad tenant. How can security of tenure provisions be designed to avoid this without compromising the benefits it confers on good tenants? More generally, what should society do about providing shelter for those for whom doing so is a losing proposition? One proposal which has been widely discussed and merits serious consideration is for the government to act as landlord of last resort. Security of tenure is potentially very valuable, but if the legal system permits the rights security of tenure confers to be seriously abused perhaps it is better to do without.[11]

Thus far, I have tended to talk about tenancy rent control as if it were a uniform policy, but of course it is not. Allowing unrestricted rent increases between tenancies is merely one provision, albeit a very important one, of second-generation rent control programs that may differ from one another markedly, both qualitatively and quantitatively. Some programs exempt new construction, others do not; some have cost-pass through provisions, others hardship provisions; the guideline rent increase provisions in some will be binding with modest rates of inflation but in others only when inflation is high. Market conditions also differ substantially across jurisdictions. For these reasons, any broad generalization concerning the desirability of second-generation rent controls generally or tenancy rent control specifically should be viewed with suspicion. Most second-generation rent con-

[11] A final aspect of security of tenure is that it provides protection against punitive eviction of tenants who legally oppose the landlord's interests, by for example organizing a tenant's group or taking legal action against the landlord for avoidance of his obligations under the terms of the lease.

trol programs which do not permit unrestricted rent increases between tenancies would be improved by permitting them. But whether a particular tenancy rent control program is better than no rent control program depends on the details of the program, the state of the market, the weight one attaches to improved security of tenure relative to the deadweight loss due to controls, and the jurisdiction's politics of rent control.

4. Conclusion

An increasingly large proportion of jurisdictions that apply rent controls now include a provision which permits rents to be increased without limits between tenancies. The second-generation rent control programs that contain this provision have been referred to as tenancy rent control since rent control is applied within a tenancy but not between tenancies.

This paper looked at both the positive and normative aspects of tenancy rent control. Tenancy rent control is qualitatively different from other forms of rent control in not being cumulative; rather than controls generating greater and greater efficiency losses as the duration of their application increases, in a stationary economic environment tenancy rent control would lead to a new steady state. Relative to the unregulated market equilibrium, this steady state entails various potentially quantifiable deadweight losses but also improved security of tenure. Economists have traditionally analyzed rent control assuming the housing market to be perfectly competitive. With this assumption, any form of rent control is harmful. But we now recognize that market imperfections abound. When these are taken into account, a well-designed rent control program can be welfare-improving. This general observation is however hardly a compelling argument in favor of tenancy rent control; a potentially persuasive case for tenancy rent control needs to establish not only that it is a particularly effective policy in mitigating particular market imperfections but also that the benefits from mitigating them outweigh the conventional deadweight losses that tenancy rent control gives rise to. The paper argued that there are imperfections which lead the market to provide insufficient security of tenure, and that tenancy rent control is a particularly effective policy for improving security of tenure. Whether tenancy rent control is on balance harmful or helpful depends on the details of the program, the state of the market, and also on how much value is at-

tached to improved security of tenure. I believe that insecurity of tenure seriously undermines the quality of life of many of the less advantaged in society, and therefore that tenancy rent control merits serious attention by economists and serious consideration by policy makers.

The paper examined the effects of tenancy rent control applied to a housing market that was previously unregulated. The situation in Sweden, where strong rent controls have been applied over an extended period of time, is quite different. In that context, decontrolling rents between tenancies would provide a method of partial rent decontrol. I hope that at least some of the points I have raised will be useful to Swedish housing economists who examine tenancy rent control from that perspective.

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