

**Rent Control:
Academic Analysis and Public Sentiment**

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abstract

The last century witnessed several waves of rent controls in industrialized market economies producing distinct types of regulation. This essay reviews the historical development and gives a critical review of recent advances in the theoretical analysis of rent control. There remains a large gap between the economist's approach to rent control and the concerns which drive the public discussion. The former rests on time invariant features of the housing market and on fully rational agents, whereas the latter is about temporary emergencies and the protection of households which are less able in dealing with business affairs.

”Economists have the least influence on policy where they know the most and are most agreed; they have the most influence on policy where they know the least and disagree most vehemently”.

attributed to Alan S. Blinder

Introduction

Until recently, the unambiguous condemnation of rent control as a folly of bad economic policy, was about the only statement on which academic economists could almost unanimously agree in questionnaires on their professional opinions. This wide consensus within the profession stood in marked contrast to their negligible influence on the public debate on rent control. However, over the last couple of years doubts emerged as to whether the self assured verdict had a solid base in economic theory or in empirical evidence. In the ensuing ‘revisionism on rent control’ it was argued that:¹

- the traditional text-book model of rent control has in fact very little to say about the likely effects of the intervention,
- real world rent controls are more complex than assumed and their impacts will depend to a large extent on the details of the regulation,
- empirical evidence is fragmented and far from conclusive,
- housing markets suffer from imperfections, which create scope for well designed rent control even to improve the efficiency.

As the analysis advanced, becoming more realistic and more complex on the way, the clear verdict on rent control was replaced by a more opaque picture consisting of partial, more modest, and sometimes conflicting insights. Will this move to normality be enough to increase the influence of economic advice?

This essay argues that, in spite of some progress, this is not very likely for two reasons. First, the economic analysis of rent control tends to address long term

¹For a more detailed review of the traditional arguments against rent control see Hubert (1991), Arnott (1995) and Arnott (1997).

issues, while much of the initial public concern is over a short term emergency. Second, even with respect to long term issues, there is little common ground between the economists' approach, stressing information problems and contractual incompleteness, and the dominant concerns outside the profession, which appear to center around limited rationality on part of the tenants.

The first section takes a brief look at the history of rent controls. Initially most measures were aimed at preventing landlords from reaping what was perceived to be a 'windfall profit' resulting from some sort of unexpected emergency. It also demonstrates the diversity of rent control measures, in particular when subsequent reforms are taken into account. In section 2, I discuss stylized features of rent control and suggest to distinguish two idealized variants, the 'transfer model' and the 'regulated tenure model'. Section 3 reviews selected recent attempts to find possible positive effects of rent regulation in imperfect housing markets. The final section asks how these recent advances relate to the public perception of the issues in rent control and draws some conclusions for future research.²

1 History of Tenure Regulation

In spite of severe urban housing problems in the industrializing countries in the 19th century, rent control was not a political issue until the first world war. The disruptions of the war prompted all belligerent nations (and some others as well) to introduce special measures in an attempt to protect the tenant against the hardships resulting from the unexpected crisis.³ Initially, some countries applied rent control only to the regions directly affected by the warfare or to households of military personal. Later, as the coverage was extended, only new construction remained exempted. These measures clearly favored tenants at the cost of landlords, notably by depressing rents below their free market level, granting tenants' security of tenure

²I admit that 'public perception' is a vague and potentially misleading notion. In this essay it shall refer to the concern of informed independent laymen, not to thinly disguised lobbyism which can be found in any field of economic policy.

³A comprehensive overview over European tenure regulation after the first world war is given in two reports of the International Labour Office (1924), (1930). On the United States of America see Drellich & Emery (1939).

if they had none, and enabling them to prematurely terminate fixed term leases.⁴ However, they have to be seen in the context of other price controls and measures to safeguard landlords, such as restrictions on the increase of mortgage interest rates, prolongation of mortgages, or restrictions on foreclosures. At the time of introduction, the new tenure laws were only part of a much more comprehensive interference of the state with the private economy which was clearly meant to be temporary.⁵ In order to prevent loopholes, the legislation had to support the rent-ceiling with mandatory tenure security and other restrictions on contracting in the rental housing market. While the restrictions on rent gradually faded out in the late twenties and thirties, other elements of the newly created tenure laws, notably the provisions for security of tenure, often remained intact.

In the wake of the second world war rent ceilings were reintroduced, respectively reinforced, on a large scale. Again, the introduction of the measures was unspectacular. It was only after the hostilities had finished and the economies were under reconstruction when controversies emerged on how to phase out rent controls.⁶

Post war Germany, facing the most acute housing scarcity of the western countries, resorted to the ‘Wohnungszwangswirtschaft’ which combined strict rent control of all pre 1948 premises with the assignments of tenants by public authorities. While the allocation of dwellings was left to the market as soon as the worst scarcity was resolved, rent controls and tenure security were maintained until the sixties. Then the restrictions were lifted whenever the estimated housing deficit had fallen below three per cent. In the late seventies only West-Berlin remained under war-time rent controls which survived well into the nineties. In France the crude freeze on rents was only short lived. As early as 1948 an elaborated control-scheme has been set up which applied mainly to the larger communes, the smaller ones becoming decontrolled. During the fifties and sixties the number of communes within the

⁴In France, as in some other countries in the Latin-law tradition, fixed term leases were common. Hence, the first rent control packages at the onset of the war entitled families of drafted soldiers to give notice to quit during the term.

⁵For example in Britain, the rent controls were introduced by the ‘Increase of Rent and Mortgage Interest (War Restrictions) Act’.

⁶A comparative view on the legislation after the second world war is provided by Harloe (1985), Brenner & Franklin (1977), Duclaud-Williams (1978), and Hubert (1991). For a brief overview and further literature see also Arnott (1997)

system decreased and many of them allowed for vacancy decontrol. By the mid-seventies, old style rent control was mainly to be found among the low quality housing stock in Paris. In Great Britain the first serious attempt to dismantle war time rent control was carried out through the Rent Act of 1957, according to which all dwellings with a rateable value above a certain limit were to be decontrolled. In addition, the bill provided for decontrol by vacant possession, regardless of rateable value, and allowed for a general rise of controlled rents. Tenants in decontrolled dwellings lost security of tenure beyond a one month's period of notice. The USA, confronted with a modest housing shortage by international standards, was quick to dismantle it all over the country with the exception of New York City. Here, the legal criterion of a vacancy rate of less than five per cent being prime facie evidence of a continued housing shortage, prevented the deregulation. Vacancy decontrol was allowed for apartments in small structures and new buildings were exempted.

In the late sixties and early seventies, when the dismantling of war-time interventions was almost completed, a third wave of rent controls swept through the industrialized countries. Though the situation was particular to every country, accelerating inflation provided much of the initial drive for the re-regulation. In many instances landlords were benefiting from real devaluation of mortgages and fixed interest payments. Although real wages were increasing on the average, those tenants depending on nominally fixed incomes faced some unexpected hardships. Notwithstanding these parallels, the difficulties were clearly minor compared to the interruptions during the wars and the introduction of new regulations remained controversial. Moreover, the legislation reflected more general concerns about the operation of the rental housing market, putting a new emphasis on tenure security and regulated rent increases during the term rather than simply on keeping rents down.

In West Germany the Tenure Security Act of 1971 (Wohnraumbündigungsschutzgesetz) provided the tenants with an infinite term and substantial protection against eviction. The new legislation covered all dwellings but it did not impose limits on the initial rent of a new lease. Only subsequent increases were limited to the level reached by comparable accommodations (Vergleichsmiete). The regulation of rent-reviews is necessary to protect sitting tenants against economic eviction. In order to justify an increase of rent, the landlord has to refer to a public index provided by the local authorities (Mietspiegel) or to at least three comparable dwellings commanding

the higher rent.⁷ Initially the ‘Vergleichsmiete’ was understood to be some sort of average of rents for old and new contracts. In times of high inflation or a tightening market this resulted in a large gap between actual market rents for new leases and contractual rents for sitting tenants. Later, the ‘Vergleichsmiete’ was determined by those lettings which were initiated during the last three years, enabling rents in established tenancies to adjust faster to changing market conditions.

In France a temporary freeze on rents was imposed in 1976 as one of several measures to curb inflation. It gave way to permanent regulation which made a tenure of three years for landlords who are private persons and six years for legal entities. Even at the end of the term the landlord could only give notice to quit for a limited set of reasons. Initially, rent increases for new contracts as well as during the term were set by collective negotiations among the organizations of tenants and landlords. Later, the landlord was allowed to charge market rents whenever the lease came up for renewal, but increases during the term were limited by the index of construction cost.

Britain was slowest to dismantle war time rent controls and first to reintroduce rent regulation by creating ‘protected tenancies’ in 1965. The legislation covered all rented housing, including new construction, and provided tenants with tenure security safeguarded by ‘fair rents’. These were assessed by public rent officers taking into account the ‘value of the premise’ while ‘disregarding any scarcity’, as well as particularities of the tenant in question. Not surprisingly, ‘fair rents’ used to be set well below market values. Hence, in Britain rents for new leases remained depressed, and, as a rule, dwellings were sold into ownership as soon as they fell vacant. In 1980 ‘assured tenancies’ were introduced providing the tenant with security of tenure while allowing the landlord to charge ‘market’ rents. The initial rent was freely negotiable. Any rent–updating could be made subject to approval by the rent–officer who had to base his decision on the rent–level reached by comparable dwellings.

In the early seventies rent controls reemerged also in the US, among others in Washington D.C., Miami Beach, Boston, Cambridge, Berkeley, Santa Monica, San Francisco, Los Angeles City. There have been large differences concerning the breadth

⁷Apart from the usual procedure to increase the rent of a sitting tenant, there are some special provisions allowing the landlord to quickly pass through cost of major improvements and higher interest rates. There is also a maximum floor for rent increases of 30% in three years.

and scope of the measures (the flexibility of rent adjustments, vacancy decontrol, eviction controls as well as restrictions on condominium conversion). While some schemes did little more than restricting rent increases during the term to a limit somewhere near by the inflation rate (allowing even for higher increases if justified by cost), others resembled war time interventions. In New York City the ‘Rent Stabilization Program’ abolished vacancy decontrol and set up a complex litigation system, combining industry self-regulation with supervision by governmental and public interest bodies. After some more changes in the mid-seventies an apartment could be relet at market rents upon falling vacant, but came under the rent stabilization system thereafter.

The development in the late eighties and nineties did not follow a clear pattern. After decades of stringent rent controls the UK completely liberalized contracting in the housing market. In other countries such as Germany, regulations were even tightened in the early nineties. Overall rent regulation appears firmly established in large parts of the continent, while it is on the backtrack in the anglo-saxon world.

2 Stylized Types of Rent Control

Every sensible discussion of the motives behind as well as the likely impacts of rent controls has to account for the diversity of the regulations. At least two stylized types of rent control should be distinguished. The first, closely related to war time emergencies, attempts to force a transfer from the landlords to the tenants. Important features of the ‘transfer model’ of rent control are:

1. The rent which can be legally charged for a dwelling is fixed below market rent, usually at its historical level.
2. The tenant cannot be evicted except for a limited set of reasons, but may be granted the right to give notice to quit if the original contract prevented him from doing so.
3. The coverage of the regulation is only partial, e.g., limited to the existing stock, certain regions, certain types of dwellings, or old leases.

Since this type of intervention was considered as temporary, eventually giving way to full contractual freedom, deregulation was often achieved by reducing the coverage, i.e. through vacancy decontrol.

The second type of rent control emerged only in the third wave. I will term it ‘regulated tenure’ because, akin to regulation of labor and insurance contracts, its focus is on the lease rather than the dwelling. It is the combination of three features which distinguishes the regulated tenure model, both from the forced transfer model as well as from complete contractual freedom in the housing market:

1. Tenure laws provide the tenant with considerable (mandatory) security of tenure.
2. Rent updating during the term is regulated but there are little or no restrictions on the initial rent.
3. The legislation is meant to be permanent and almost comprehensive in its coverage.

Obviously, the first and second features are intimately related. In the absence of some binding rule for the updating of rents for sitting tenants a landlord could easily circumvent tenure security by a sufficiently drastic raise in rent (economic eviction). And whenever the contractual rent for a sitting tenant falls below the initial rent for new contracts, protection against eviction is necessary to prevent the landlord from giving notice to quit. However, as initial rents for new lettings are free, landlords will require a compensation during the initial negotiations for whatever tenure laws stipulate in favor of the tenants. Though, at the time of introduction, they still suffer a temporary disadvantage, because of uncompensated changes imposed on existing contracts.

The reason for suggesting the distinction between the transfer model and the regulation model is that both types of rent control appear to be driven by different motives and pose rather different issues for research.

From my reading of the historical evidence it appears plainly clear that the introduction of the transfer type was motivated by the desire to prevent unexpected hardships and windfall profits emerging from exceptional circumstances, which at their time were considered to be well beyond usual economic risk. These measures

were enacted as a fast response to rapid and complex change in the economic environment which by and large favored landlords and harmed tenants. However, they were never meant to be a device for redistribution of income from rich to poor. This kind of arguments were raised only later during the long lasting controversy over the right way and speed of dismantling controls. The original purpose of the transfer type of intervention was not social redistribution, but to keep landlords and tenants roughly at the economic level, which they had achieved before the onset of the disruption.

The motives behind the regulated tenure variant are more difficult to discern. Though again, unexpected circumstances such as accelerated inflation facilitated their introduction, the measures reflect more general concerns about shortcomings of contracting in the housing market. This point has been nicely summarized as follows:

‘In the solicitor’s paradise where every man took legal advice before entering upon a tenancy there would be little need for rent controls... If we accept the desirability of the private contract method of insuring a certain rent, a fixed term and security of tenure over the term, we should be able to construct a similar degree of security for tenants too poor or illiterate to take advantage of the legal forms available’.⁸

Common sense suggest that most tenants (and landlords) lack the perfect rationality which enables them to imagine all future possibilities, attach probability weights and calculate the appropriate price for the security of tenure, alternative rules for the updating of rents etc. Many people outside the economic profession appear to consider tenure regulation as akin to a quality or safety standard for a contract which governs an important aspect of family life. I will come back to this argument in the last section.

The two types of regulation are not only driven by different motives, they also raise distinct challenges for the economic analysis. For example, in the case of the forced transfer model the impact on supply is less clear than often suggested. Since the rent ceiling does not apply to new construction, the crucial question is, how does a partial price control effect the equilibrium rent in the unregulated sector? If these should be higher than rents in a completely deregulated market, then rent control would boost

⁸Nevitt (1970), p.134/35.

new construction. Rents in the free sector depend on the spill-over of demand from the controlled to the free sector, which in turn is determined by the rationing of the controlled units.⁹ In the case of the regulated tenure model we obtain a completely different picture. The initial rent of new leases still acts to clear the market, hence price rationing is not put out of work. However, new construction is also subjected to the regulation. In principle, the impact of the regulation on supply is clear: if the regulated contract is inferior to the contract which landlords and tenants would have chosen in the unregulated market, tenants will be less inclined to spend on housing, causing the price to drop and supply to decrease. The opposite would be true if the mandatory contract is better than the market contract. The answer requires, therefore, the comparison of different types of contracts.

3 Economic Justifications of Rent Control

The ‘revisionism on rent control’ within the academic profession was fostered by progress in the theoretical analysis of imperfect markets. There is little doubt that search-cost, information problems, and mobility cost play a major role in the housing market. In fact, some of the more realistic models of the housing market were developed in an attempt to improve our understanding of rent controls. As it turned out, when accounting for the particularities of the housing market, the analysis came up with some rigorous arguments in favor of the intervention. In the following I will sketch three lines of such reasoning, each addressing one of the important features of rent control: the rent ceiling of the transfer type, tenure security, and regulation of rent reviews.

Rent Ceiling

At first glance the housing market seems pretty close to the ideal of a perfectly competitive market: economics of scale are negligible, there are few barriers to entry and exit, and, as a rule, the number of competing suppliers is large in comparison to most other markets. However, housing is also highly heterogeneous, preferences of households are idiosyncratic, and search cost are substantial. Hence, trading takes

⁹See Fallis & Smith (1984) and Hubert (1993) for a detailed analysis of this question.

place in thin markets, with only a limited number of landlords effectively competing for a prospective tenant. As a result, the housing market features elements of monopolistic competition which may provide a justification for rent control as a correction for distortions resulting from landlords' market power.¹⁰

Arnott & Igarashi (2000) present the following analysis. Upon entering the housing market tenants collect information about available units. However, easily accessible information is insufficient to make the appropriate decision. Flats differ in too many aspects which can not be communicated. Other information is soft and has to be verified. Hence, only a small sub-set of vacancies is selected and visited, which requires time and effort. When the home-hunter finds a flat which suits his taste he may accept it even if the price is somewhat higher than for other flats of the same category. The alternative would be to continue the costly search process. If there is plenty of housing on the market, tenants will be able to find a very good 'match' with reasonable effort. If only few units are vacant, search will be more difficult and tenants will put up with lower match-quality.

Since landlords understand that product differentiation and lack of transparency gives them market power, they charge a rent above marginal cost. This reduces somewhat the chances to strike a deal within any given period of time. But they do not mind a slight increase in the vacancy spell, because a higher rent in the future will reward them for the lost income. These extra profits trigger market entry and in the long run equilibrium 'excess' capacity will manifest itself in form of vacant housing, not in form of higher profits.

However, as usual in models of monopolistic competition, it is not clear on a priori grounds whether capacity is in fact 'excessive'. A higher vacancy rate also has advantages. It increases the choice for the tenant and makes it easier for home-hunters to find units which suit their tastes, hence, it reduces search cost and improves the average quality of the matches. The trade off, therefore, is between low rents and a large variety to choose from. When deciding upon the rent, every landlord wants to exploit his market power, which suggests that rents and vacancy rates are too high. But on the other hand, with respect to the vacancy spell, he considers only the lost revenues and ignores that a vacant dwelling increases the search efficiency and

¹⁰Basu & Emerson (2000) simply assume market power while Arnott (1989) and Arnott & Igarashi (2000) derive from a search-model with endogenous vacancy rates.

match quality. This positive externality suggests that vacancy rates and rents may also be too low in equilibrium. Arnott & Igarashi (2000) developed a formal model in which the first effect dominates the second under fairly general assumptions. This implies that the ‘natural vacancy’ rate is too high and a small decrease of rents below their long run equilibrium would be welfare improving. Critics of rent control argue rightly that the vacancy rate is decreased and search efficiency reduced. But since both are too high in the market equilibrium, the gains from reduced rental payment outweigh the losses from reduced match-quality for moderate rent controls.

To the best of my knowledge, this kind of analysis provides for the only rigorous argument in favor of a rent ceiling, which has been put forward in economic theory. However, it offers only little intuition as to why the natural vacancy rate is excessive. Hence, it is difficult to judge whether the result is a particularity of the model, developed in Arnott & Igarashi (2000), or a robust implication of economic principles.

Tenure Security

As has been argued above, the issue of tenure security looms large in the regulated tenure variant of rent control. A number of countries protect the tenant against eviction, provided the landlord has no ‘just cause’ for doing so (e.g., breach of contract, rent arrears). Tenants value this right for a number of reasons: moving is inconvenient and expensive, people tend to develop a psychological attachment to their flat and neighborhood, and much of the tenant’s investment in renovation, furniture etc is sunk. However, the mere fact that tenants appreciate tenure security, does not justify that the state imposes it by law. As with any other good, one would expect the market to provide long-term contracts with tenure security, if the willingness to pay is large enough to cover the cost of provision. Hence, the real challenge is to explain why the market may fail to supply contracts with tenure security.

The basic argument runs as follows (Hubert (1995)). In order to keep cost of maintenance and administration low, a landlord expects his tenant to minimize wear and tear, avoid trouble with neighbors etc. Many aspects of the tenant’s conduct, however, are not contractible — being unobservable by a third party acting as an

arbitrator or too vague to be explicitly stipulated. So at least part of these tenant related 'service costs' are born by the landlord. Some tenants are easier to deal with than others, but a landlord will not be able to identify them for sure when filling a vacancy. He will only find out during the course of tenure. The scope to react then is determined by the nature of the contract chosen in the first place. In the case of a long-term contract with tenure security, the landlord has to put up with high service cost until the tenant leaves voluntarily. To the extent that service cost are non-contractible they will not amount to a clear cut breach of contract. However, with a short-term contract he may evict high cost tenants or raise their rent. It has repeatedly been observed that long-standing tenants pay less than those who entered their contract more recently (Börsch-Supan (1986), Guasch & Marshall (1987)). Such a tenure discount is natural if landlords try to reduce the turnover of 'low cost' tenants.

With tenure security all tenants are treated alike, whereas high-cost tenants expect a higher probability of eviction or rent increases when entering a short-term contract than low-cost tenants. Hence, contracts offering tenure security are particularly attractive for high-cost tenants and will, therefore, suffer from adverse selection. Or to put it the other way round, low cost tenants have an incentive to differentiate themselves from high cost tenants, by foregoing tenure security. By accepting the risk of eviction they will substantially reduce their rent because landlords anticipate that only good tenants will do so. However, the rent for high-cost tenants will increase accordingly. This redistribution among tenants is achieved at some cost, the moving cost in case of eviction, but eviction serves no social aim since the evicted tenant rents from another landlord anyway. Due to adverse selection, the private cost of providing tenure security surmounts the true social cost. Hence, in equilibrium the provision of tenure security is too low.

Again, the claim of market failure is fairly robust, though it does not imply that making protection against eviction mandatory for all leases is warranted. If one accounts for genuine cost of providing tenure security, resulting for example from risk-aversion on part of the landlords, impaired incentives to keep service cost low on part of the tenants etc., such a drastic intervention may be too much of a therapy, forcing tenants to pay a premium for the insurance which surmounts their valuation of it.

Rent Reviews

The regulation of rent reviews can be seen as a complementary measure for tenure security, but it can also be analyzed in its own right. As mentioned above, various countries have tied rents in established tenancies to different indexes: inflation rate, construction cost, new rents for comparable dwellings. The first scheme implies that rents are fixed in real terms independently of the development in the housing market, whereas the last scheme makes rents in established tenancies respondent to housing market shocks. This raises the question whether indexation should be left to the market or be centrally regulated.

The issue is also interesting because an important objection against rent control is the unequal treatment of otherwise equal tenants. Those who are lucky to be rationed in, usually the sitting tenants at the time of introduction, obtain housing exceptionally cheap. Those who are unlucky to be rationed out, experience greater hardship than necessary, because the protected ‘sitting birds’ have little incentive to economize on space. However, a similar phenomenon will arise in almost any market in which exchange is governed by long-term contracts. In a smaller or greater measure all forms of tenure inhibit the landlords’ (or the tenants’) immediate response to market forces and new opportunities, because that is what they are for. A contract which puts no restriction at all on the contracting partners behavior is not worthwhile to be written. Hence, by understanding the logic behind private risk-sharing in long term contracts we may enhance our understanding of the trade-offs faced by the transfer type of rent controls.

Moving cost and ex-post indivisibility are features of the housing market which create a strong interest for ex-ante insurance against ex-post price uncertainty (Hubert (1996)). Suppose, a tenant selects the optimal size for his new home at current rents. After moving in, he cannot change his housing consumption — except by moving again to a smaller or larger dwelling or by subletting part of his flat, which entails a substantial loss of privacy. Thus, there are discrete and nontrivial cost of adjusting consumption in a response to a change of price in the housing market. In contrast to most other goods, the consumption of which can be adjusted on short notice at little cost, uncertainty over future rents translates directly into income risk for immobile households. In fact, the same holds true for many landlords.

If landlords and tenants can negotiate a long-term contract, they have an interest to protect themselves against the vagaries of market rents for new leases — at least to the extent that these are not related to the cost of provision or the utility derived from consumption. Hence, it is their interest to fix the real rent in advance, isolating the contract against the development of the market for the duration of the term.¹¹ Thus, private contracting will result in a situation similar to the one created by rent control. Tenants who have old contracts, at a time when the housing market tightens, will be in a favorable situation compared to those who enter the market.¹² Their incentive to move will decline and the turnover rate will drop as the market tightens. As the critics of rent control rightly pointed out, this will exacerbate the crisis and raise market rents for new leases in times of tight markets, by reducing the incentives to economize on space. However, every single landlord-tenant pair is concerned only with individual risk-sharing within the contract and ignores the effect of their indexing rule on future equilibrium rents. The optimal indexation, in contrast, has to strike a balance between the insurance provided by stable rents within the contracts and the stabilizing effect of a high turnover on future market rents.

In Hubert (1996) it is shown that privately optimal contracts are generally not efficient. Furthermore, if tenants are risk-averse with respect to market rents for new leases, private contracts provide for too much insurance within the contract, resulting in too low a turnover and excessively volatile market rents. Hubert (1996) analysis an environment were the cost and gains from moving are known only to the tenants. Hence, every single contract solves a trade off between efficient risk sharing and inducing efficient moves. However, the individually rational indexation scheme sets the rent too low, because it ignores that by increasing the contractual rent it will increase the aggregate turnover rate which stabilizes market rents for new contracts.

¹¹In practice their ability to do so may be limited, because the more rents for new contracts increase or decrease, the stronger becomes the interest of one side to renege on its promise. Hence if contracts are incomplete, they can only provide partial insurance, for example by limiting the time for which the rent is fixed.

¹²It is worthwhile stressing that this happens all the time in the (unregulated) market for commercial rentals, where five to ten year leases with fixed real rents are common.

4 Bridging the Gap

There is little doubt that the revisionism on rent control is built on arguments which are firmly based in established economic theory. The credibility of the new, cautious arguments in favor of certain forms of rent control is further enhanced by the fact that they have been derived from assumptions which are able to explain empirical features of the housing market, such as the ‘tenure discount’ and cycles in the turnover rate, which cannot be explained in the framework of perfect, competitive markets. Nevertheless, the gap between economic theory and housing policy remains large, and there appears little common ground between the approach of housing economists and the public perception of housing market problems.

Take for the example the economic analysis of rent ceilings. Arnott & Igarashi (2000) justify moderate ceilings for all dwellings, including new construction, because the housing market features elements of monopolistic competition due to its intransparency. Notwithstanding the intellectual merit of the argument, it is obvious that this is a time-invariant feature of the market, which appears to be of limited help for a rational discourse on rent control at the time of an acute crisis. At the time of the introduction of rent-ceilings, the worry was definitively not about long term vacancy rates being too high but rather about temporary price hikes triggered by very low vacancy rates. In fact, those controls featuring a rent ceiling (the transfer type) typically exclude new construction, while those with a broad coverage (the regulated tenure type) put little restrictions on the initial rent of new leases and are therefore unlikely to achieve the permanent transfer, which is necessary to decrease long run supply and equilibrium vacancy rates. Strictly speaking, monopolistic competition does not justify commonly observed types of rent control.

The analysis of optimal contracts may be in fact more useful for the understanding of emergency style rent controls. My impression is that at the time of introduction the widespread support for rent ceilings resulted from the fact that many people sensed that they achieve ex post, what private parties would have accepted as reasonable risk sharing ex ante if they had foreseen the possibilities. Recall, that wars as well as accelerated inflation were a result of deliberate policies and not a day to day economic risk. It is not surprising that rental arrangements at the time were ill prepared for these low probability events. Public sentiment apparently accepts

that private contracts are incomplete for whatever reasons and that, at least in exceptional circumstances, the state has a role to step in and impose ex-post what reasonable complete contracts would have stipulated ex-ante. Obviously, sympathy for such a position will depend to some degree on ideological attitudes towards the general role of the state in society, and there is a danger of putting too much benevolence and rationality into economic policy. But at least many features, such as fixing the rent at historical levels, excluding new construction and sometimes new contracts, are consistent with this interpretation.

In the public discussion it is often argued that particular features, such as tenure security, certainty over rents etc. are desirable properties of good rental contracts, and should therefore be prescribed by law. This is clearly short sighted, as if these features were truly desirable in the sense that the tenants valuation is high enough to compensate the landlords for any disadvantages, we would expect the market to provide these features without state intervention. Hence, if they are not found in real life, they are probably not as desirable as assumed. As a rule, I think it is wise to maintain this presumption unless the opposite is proven. Hence, an important contribution of the contract theoretical approach to rent control was the insight that, due to information asymmetries and contractual incompleteness, the market may fail even if the partners are able to negotiate bilaterally optimal contracts. However, much of the cost of regulating contracts result from the fact that uniform contracts will fit the particular needs of the partners less well than individually negotiated deals and I am not aware of any formal analysis of this trade off.

Finally, even if a particular problem can, in principle, be fixed through well designed rent controls, it may not be the most suitable way to do so. I was often stunned, how easily economists misread rent control as ill designed distribution policy, just to point out that social aims can be achieved more efficiently through a system of corrective income taxes and income subsidies. (Given all the incentive problems with income based transfers, this seems somewhat naïve.) However, when it comes to the correction of market failures, of the type analyzed in Arnott & Igarashi (2000), Hubert (1995) and Hubert (1996), corrective taxes are in fact the instrument of choice. A small tax on housing, a tax on terminable contracts, and a subsidy for moving, respectively, would do at least as good in correcting distortions in the aforementioned models as rent ceilings, mandatory tenure security, or centralized

indexation of rent reviews.

The general thrust of this essay is that housing economists are well advised to take seriously the details of rent control, the circumstances at the time of introduction and the public mood surrounding these events. This is not to say that the latter should be accepted at face value. But the laymen's thinking about tenure regulation provides stimulating food for economic thought.

Consider the hypothesis from the quotation above, that tenure regulation would not be needed in the 'solicitor's paradise' where everybody takes legal advice. I disagree. Suppose that with some probability a particular conflict of interest may arise during the course of the tenure. Suppose further, there is an efficient ex-ante solution for this contingency. However, leaving the issue unsettled may benefit the landlord in ex-post bargaining. Then, the tenant may be afraid of overlooking something when signing the contract. Furthermore, legal documents have their own language, not readily accessible to everybody, and the wording may be chosen to mislead common sense. Rational tenants will be fully aware of the fact that they may be cheated. In principle, landlords would prefer to offer efficient contracts provided that tenants recognize these and honor them with higher rental payments. However, since he cannot be trusted, the landlord may lack a credible way of assuring the 'quality' of the proposed contract. If the matter is not very important, there will be cheating in equilibrium. Low quality contracts will drive high quality contracts out of the market. If the matter is sufficiently important we may end in the 'solicitor's paradise' where everyone spends resources on legal advice to screen out low quality contracts.¹³ However, in both cases a legally binding framework for contracting may improve welfare. In the first by raising the tenants willingness to pay for a product of higher quality more than the landlords cost of providing the quality. In the second by rendering costly legal advice unnecessary. In a sense, regulation may be needed exactly in order to prevent everybody from taking costly legal advice.¹⁴ Again, contrary to what is often perceived outside the academic profession, rationality does not imply that there is no role for state intervention.

¹³Building a reputation for high-quality rental contracts will not work for long term contracts, since trading is by definition infrequent and rarely with the same partner.

¹⁴I am not aware of any rigorous analysis of this issue, but I am pretty confident that it can be proven in a simple model of adverse selection and screening.

Much of the non-academic reasoning about tenure laws is based on the assumptions that some tenants are not able to reasonably defend their interests on their own. Judging the merits of this assumption is beyond the scope of this essay. As a matter of fact, people differ substantially as to their cleverness in dealing with economic affairs and housing is important enough to be worried about the faith of the less capable ones. However, it is not clear on a-priori grounds whether limited rationality would lead the tenant to neglect or to overemphasize on tenure security and rent stability. My personal impression from Germany is, that many people are in fact overinsured against fairly trivial risks in other areas. If the gap between economic theory and public debate on rent control is to be narrowed, economists have to account explicitly for bounded rationality in their analysis of contracting in the rental housing market. This may not only yield a more balanced judgement on rent control, but also deepen our understanding of other features of the market.

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