

## **Economic analysis of tenancy control : International experience**

### **Summary**

- Based on academic research in the past 40 years or so, this paper examines the economic implications of tenancy control on the residential property market from a theoretical and empirical perspective.
- Theoretically, in a competitive market, flat rentals determined by the operation of market forces reflect a number of macro and micro factors. In the absence of any market failure, any government intervention that artificially suppresses rents will cause market distortions and misallocation of resources.
- Empirically, international experience indicates that tenancy control would result in a further tightening of demand-supply balance in the leasing market, deterioration in flat conditions, lower tenant mobility, spillover to uncontrolled flats and rent-seeking activities.

## **Introduction**

Different forms of tenancy control have been adopted in various economies, aiming to protect tenants from high rents. Over the years, many academic studies have been undertaken to examine their actual effects and effectiveness from an economic perspective. This paper first discusses whether tenancy control can be justified from an economic angle. It then examines the implications of such control for the residential property market, drawing reference to both theoretical arguments and empirical evidences.

## **Background of tenancy control**

2. Tenancy control, which usually comprises rent control and security of tenure, has been introduced in many economies since the early 1920s. Originally, most tenancy controls were introduced as temporary measures during/after war times (e.g. The First World War and The Second World War) amid housing shortage and surging rents, or in periods of high inflation (e.g. the Energy Crisis in the early 1970s). It aims at protecting tenants through a controlled, and hence possibly lower and more affordable rent, accompanied by a certain level of tenancy protection. In certain economies or cities (e.g. certain states in the US), the tenancy control regime also included provisions to ensure a fair rate of return to housing investments for landlords.

## **Tenancy control can be justified only in case of market failure**

3. In a competitive market, flat rentals determined by the operation of market forces reflect a number of macro factors including the prevalent economic environment and demand-supply situation in the property market, and also micro factors including the location and quality of the flats concerned. At this market-determined level of rent, tenants who are willing to pay could get the flats they want; landlords would receive a return that reflects the nature of investment and the cost of capital; developers would also have the incentive to build flats to meet the long-term demand for housing. Under such a situation, any government intervention that artificially suppresses rents will inevitably cause market distortions and misallocation of resources. In other words, tenancy

control will not cause market distortions only if it has no effect on rents, which however means that it does not fulfil the original purpose of helping the tenants.

4. Thus from an economic angle, tenancy control can only be justified when there is market failure, such as those stemming from unequal bargaining power between landlords and tenants or asymmetric information. There are theories (e.g. Arnott (1995 and 1997) and Arnott and Igarashi (2000)) suggesting that when there is mismatch of landlords and tenants or excessive searching cost for flats due to imperfect market information, a “mild” form of tenancy control might improve efficiency.

### **Typical features of tenancy control and the associated market distortions**

#### *(a) Rent Control*

5. In practice, the implementation details of rent control differ significantly in different regimes. For analytical purpose, it can be broadly classified into two main types, namely control over the absolute level of rent (commonly known as the “1st generation control”), or control over the rate of increase in rent (commonly known as the “2nd generation control”).

6. Both the 1st generation and 2nd generation of rent control would further tighten the demand-supply balance in the leasing market. On the supply side, a lowered rent would reduce the incentive and willingness for the landlords to lease out their existing flats. Some might turn the flats into owner-occupied flats, second-home, or even leave their flats vacant. Navarro (1985) noted that during the implementation of rent control in Cambridge, Massachusetts, about 10% of the rent-controlled housing stock was converted into non-rentable condominiums, and as a result the share of renter-occupied private units shrank from 75% in 1970 to 66% in 1980. On the demand side, the lowered rent would provide incentive for more household splits or a switch from owner-occupied to tenant household. With the increase in demand concomitant with a reduction in leasing supply, potential tenants would probably take a

longer time to search for flats, and some might never be able to find one.

7. Rent control, be it 1st generation or 2nd generation, would also result in under-maintenance of flats by the landlords. As landlords would not receive any additional rental return for their investment on repair and maintenance, they would simply let the flats deteriorate in conditions. While it is not uncommon for some authorities to allow extra increase in rents to compensate for spending on repair or renovation (e.g. Germany and Los Angeles), these mitigating provisions are usually costly to implement and cannot totally address the problem. Based on the data from eight metropolitan areas in the United States, Mengle (1985) estimated that the quality of flats in the controlled market was lower than in the uncontrolled market, on average by 7.1% in 1974 and by 13.5% in 1977. Gyourko and Linneman (1990) also estimated that controlled units have a higher probability of being “unsound” as compared with uncontrolled units in Manhattan, New York City. Pollakowski (2003) estimated that the rent deregulation in Cambridge, Massachusetts in 1994 had led to around 20% increase in maintenance investment in formerly rent-controlled buildings.

8. Furthermore, as the artificially suppressed rental returns for landlords would lower the investment demand for flats, in theory developers would have less incentive for constructing new residential buildings when there is rent control. Yet this hypothesis is difficult to prove empirically, since the coverage of the rent control changed from time to time in many economies which affected developers’ behaviours, and private construction activities also depend on a host of other factors that are difficult to model (e.g. the availability of housing land).

(b) *Security of tenure*

9. Rent control is usually accompanied by security of tenure in most economies, which stipulates that landlords could evict the tenants only under a pre-determined set of situations, such as non-payment of rents by tenants, repossession for self-uses, etc. In fact, the 2nd generation rent control will be effective only if security of tenure is guaranteed, as there is huge incentive for the landlords to get a higher rent through repeatedly evicting the existing tenants and setting up new leases.

The secured length of tenancy varies across different economies, from several months (e.g. for “assured shorthold tenancy” in the United Kingdom) to indefinite period of time (e.g. Germany).

10. On top of the impact mentioned in section (a) above, 2nd generation rent control, together with security of tenure, would have the additional effect of lowering tenant mobility. As the rent for a new lease would likely be higher than the existing rent, existing tenants would tend to stay in the current flats for as long as possible. Drawing on various empirical studies, the OECD paper “Housing and the Economy: Policies for renovation” published in 2011 acknowledged the reduction in residential mobility caused by rent control. Nagy (1997) showed that tenants in the controlled sector stayed in the same flats longer than those in the uncontrolled sector in New York City. Munch and Svarer (2002) also found that a typical household living in a more stringently regulated unit would stay in the flat longer as compared with a household living in a less regulated unit in Denmark.

11. The lower tenant mobility would induce inefficiencies in resources allocation as tenants might not move out from the flats even when the units have become less suitable for them over time. Krol and Svorny (2005) found that the lack of household mobility under rent control would lead to a general increase in commute times for the working population in New Jersey. Moreover, the lower turnover of rental units would also reduce the choices of rental units, possibly leading to higher time cost of finding suitable flats by potential tenants.

(c) *Different coverage of tenancy control*

12. As most tenancy control regulations were originally intended to be temporary, newly constructed units or fresh lettings were sometimes excluded. This would help reduce the disincentive effect on future construction of flats, but some studies (e.g. Downs (1988)) noted that developers still tended to be cautious in building new flats due to worries over the possible expansion in the coverage of rent control. Indeed, there were several instances (e.g. New York City, Hong Kong) where the coverage of rent control expanded in some periods of time.

13. As one major objective of rent control is to help the lower income households, tenancy control in many economies only covers mass-market flats or flats with rents below a certain threshold. Under such a regime, in theory future production of flats might shift towards the uncontrolled higher-end segment, leading to an even tighter demand-supply balance in the controlled mass-market segment in the long run. Again, this is difficult to prove empirically, since most authorities introduced other exemptions/measures at the same time (e.g. in New York City the Tenancy Rent Control does not apply to premises completed in or after 1974 with rent lower than US\$2,500; construction subsidies were provided in the Netherlands).

14. Moreover, when tenancy control only covers a specific segment of the market, there might be undesirable spillover effects on the uncontrolled segment. As some tenants are not able to rent flats in the controlled segment due to excess demand relative to supply, they might rent flats and thus push up rents in the uncontrolled segment. Fallis and Smith (1984) found that rent control in Los Angeles had contributed to a higher rate of increase in rents in the uncontrolled sector in the 1970s. Early and Phelps (1999) also estimated that the existence of tenancy control raised the rents in the uncontrolled sector by 13% in the United States during 1984 to 1996.

### **Rent-seeking activities**

15. As rent control artificially lowers the rental returns that could be otherwise obtained, it is just natural that landlords will try to evade the control whenever possible. Under the 2nd generation control, landlords usually charge a higher initial rent so as to compensate for the lower rental increase in future. Nagy (1997) found that the rent control in New York City had actually led to higher rents of the controlled apartments vis-à-vis uncontrolled apartments initially, though lower rents around six years later. As noted in various studies including Cheung (1974 and 1975) and Qian and Tang (2000), landlords might charge the prospective tenants a lump-sum and usually non-refundable fee under superficial terms such as “key money” or “broken furniture”, or propose informal leases for extra rents. These behaviours would lessen the distortions

brought about by rent control. Yet they would also render the rent control less effective in helping the lower income households.

## **Conclusion**

16. As shown above, tenancy control generally results in market distortion and unintended consequences. Tenancy control is a controversial subject from an economic perspective, and its implementation should be carefully deliberated and examined.

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