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THE FLAWS IN RENT CEILINGS

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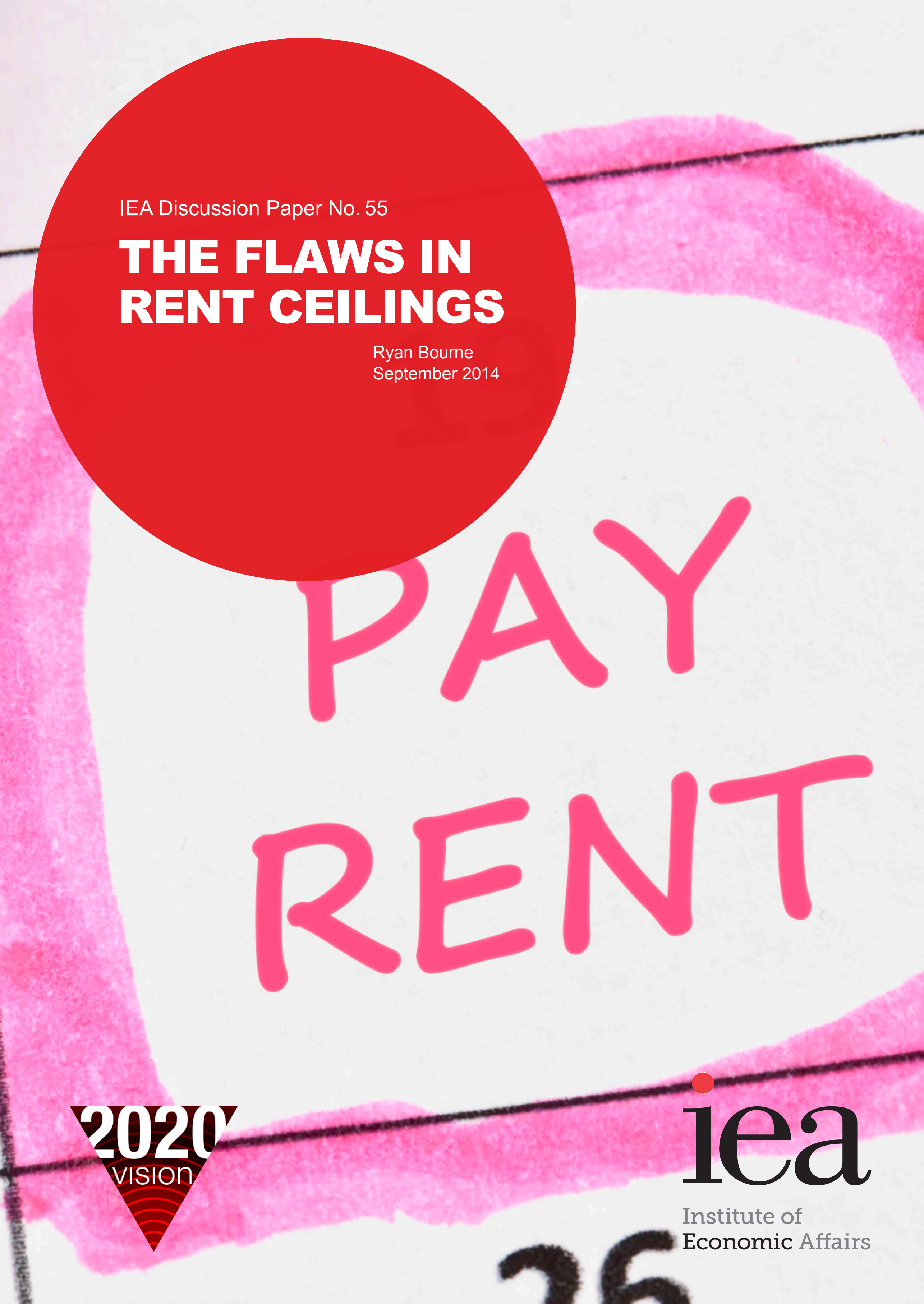

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About the author

Ryan Bourne is Head of Public Policy at the IEA and a weekly columnist for *City AM*. He has previously worked both at the Centre for Policy Studies and Frontier Economics and has written widely on a range of economic issues.

Summary

- Rent controls are probably the best researched and understood form of price control in economics. Their consequences are widely regarded as being extremely damaging and UK experience confirms this.

- In Britain, the period of rent controls between 1915 and 1989 was associated with the private rental sector collapsing from close to nine-tenths of the housing stock at the start of the 20th century to close to one-tenth by the late 1980s and early 1990s

- When rents are held below market rates, outcomes can be expected to deteriorate over time. There is a substantial literature outlining the negative effects on the quality of rentable property, as well as substantial economic efficiency costs arising due to misallocation and lower labour mobility.

- Interest groups and politicians are now advocating what are known as 'second generation' rent controls, which entail rules governing increases in rents within a tenancy together with regulation of the length of tenancies.

- In the UK, the Labour Party has advocated such controls. Whilst there would be complete freedom for landlords to set rents between tenancies, rents within tenancies would be benchmarked so that increases are linked to average increases within a locality, some measure of inflation, or both during a three-year contract. Furthermore, tenants would have great security of tenure.

- Since rents can alter between tenancies, tenancy rent controls cannot improve affordability for any group other than in the very short term. It is most likely to simply change the timing of rent costs over a tenancy by raising initial rents. Indeed, the existence of these controls may even increase market rents overall as a result of greater regulatory uncertainty and the business risk of increased security of tenure raising the returns that landlords require.

- It is likely that these so-called tenancy rent controls will improve security for some tenants. However, this will come at a cost to other tenants. Experience suggests that landlords are more likely to treat tenants badly and lower their quality of service in other ways if security of tenure is enforced by law. Furthermore, there is no evidence that existing ‘secure’ contracts are unavailable in the UK when tenants are willing to pay for them.

- Some claim that these tenancy rent controls will not be damaging because they exist in Germany, where the market is regarded as a tenant-friendly environment. However, there are huge structural differences between Germany and the UK – not least that there is significantly more development of new dwellings in Germany, making rent levels much lower in general.

- Planning liberalisation would clearly be a welfare enhancing policy and would reduce the cost of living. Tenancy rent controls would not be welfare enhancing and are, if anything, likely to increase the cost of living. Tenancy rent controls would therefore be treating the symptoms of high rental costs to appease a particular interest group. The fact that the beneficiaries are obvious and well-organised whilst those who suffer are dispersed would make this is a potentially damaging policy, which could be very difficult to reverse.

Introduction

Rent controls refer to government restrictions on the amount a landlord can charge a tenant for accommodation. They are the best researched and understood form of price control in economics, though the type of controls implemented by governments has undergone various mutations over the past century (Arnott 1997; Jenkins 2009).

Simple controls on nominal rents were implemented in many countries during and after periods of war in the 20th century to prevent alleged profiteering by landlords (Heath 2013). Unsurprisingly, they proved more difficult to abolish than to implement.

These 'first generation' rent controls in effect create 'rent ceilings' beyond which landlords are unable to increase rents. As such, they only create shortages of rental accommodation if they are set below the market-clearing rent level. A wide range of theoretical and empirical evidence suggests that in practice they did just that, with many other negative unintended consequences (Jenkins 2009).

Over time, these crude controls were therefore abandoned. More recently 'second generation' controls were implemented. These were more complex, limiting increases in rent levels alongside other forms of regulation of the landlord-tenant relationship (Arnott 1997). Such controls are often referred to using the more benign sounding phrase 'rent regulation'. Though less damaging than 'first generation' rent controls, they still have harmful consequences.

The most recent manifestation of this type of regulation has been so-called ‘tenancy rent controls’. These have recently been proposed by the Labour Party in the UK. Under this framework, rent increases would be limited within tenancies but could adjust between tenancies. It is also proposed that the length of the tenancy will be fixed – in the UK case, at three years.

First generation rent controls

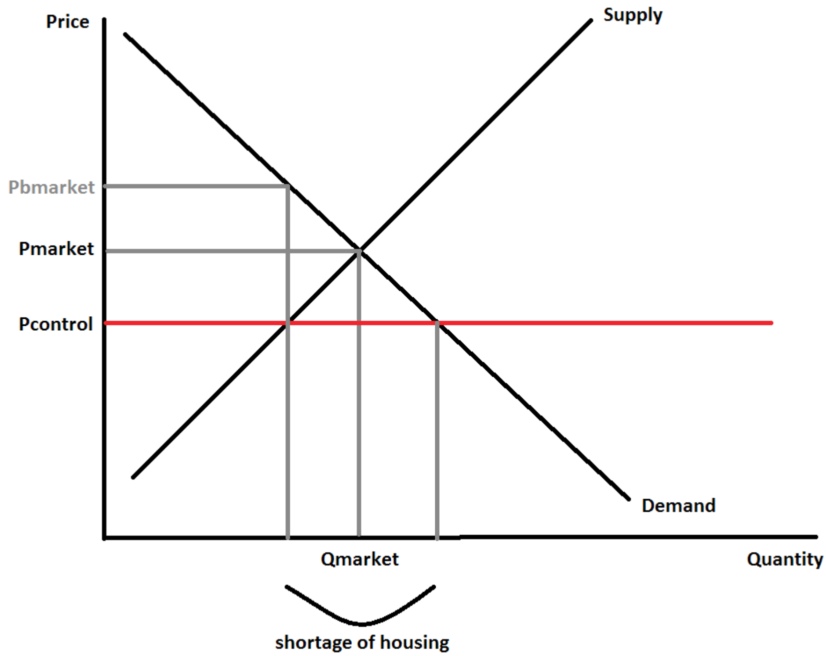
Theory

In a recent survey, 95 per cent of economists disagreed with the proposition that rent controls had a positive impact on the amount and quality of broadly affordable rental housing.[1] This is a rare consensus amongst academic economists. Lindbeck (1971) once went as far as saying: 'In many cases rent control appears to be the most efficient technique presently known to destroy a city - except for bombing'.

A ceiling on rents below the market-clearing level leads to a fall in the quality of rental property available and a reduction in the quality of the existing stock. Unlike in a competitive market, rent controls negate the ability of the price mechanism to allocate supply given a level of demand – resulting in shortages when rent controls are binding (see Figure 1).

1 IGM Economic Experts Panel: http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_6upyzeUpI73V5k0

Figure 1: Rent control in a competitive housing market



As can be seen in Figure 1, holding down rents both increases demand and decreases supply, thus creating a shortage.

However, many have argued that the competitive market framework is the wrong way to think about this problem (Dillow 2013). Instead it is suggested that landlords have a degree of market power given the very specific demands of tenants and strongly differentiated properties. This could mean that it is more accurate to think of the rented sector as having monopolistic tendencies (Arnott 1997). Rents would then be set above the marginal cost of supplying the property in a free market, such that a well-designed rent control programme could actually increase the supply of rentable properties.

Determining which framework is closer to the truth is ultimately an empirical question. Academic work has suggested that some rental markets can be uncompetitive, but often this is due to the regulatory restrictions on land use. The price elasticity of supply of rental housing should be large in a competitive market, and work in this area suggests that extensive land-use regulation reduces housing supply elasticity more broadly (Saiz 2008). Indeed, Malpezzi and Maclennan (2001) show that supply is much more elastic in the US relative to the UK. In the former, land-use planning is much less restrictive. To the extent that rental markets are uncompetitive then, this is often down to policy-induced regulations.

Given this, it is difficult to see how rent controls would help. Even if land-use planning regulations prevent building in general and keep rents and property prices higher, capping increases in rents just provides landlords with an incentive to sell property that they otherwise might have let out, or to convert properties so that their tenure type falls outside the rent control framework.

Furthermore, when reviewing the literature on first-generation rent control, Arnott (1997) concluded that the 'cumulative evidence – both quantitative and qualitative – strongly supports the predictions of the textbook [competitive] model' and, it might be added, suggests a host of other negative unintended consequences. If rent controls bind, theory would tell us that landlords would have the option to react by cutting investment in the property market, shifting investment into areas where there are no rent controls or allowing properties to fall into disrepair. We would also expect that a sustained suppression of rents below market clearing levels would lead to a progressively deteriorating rental property market. This is exactly what economists have found.

Shortages of rental property

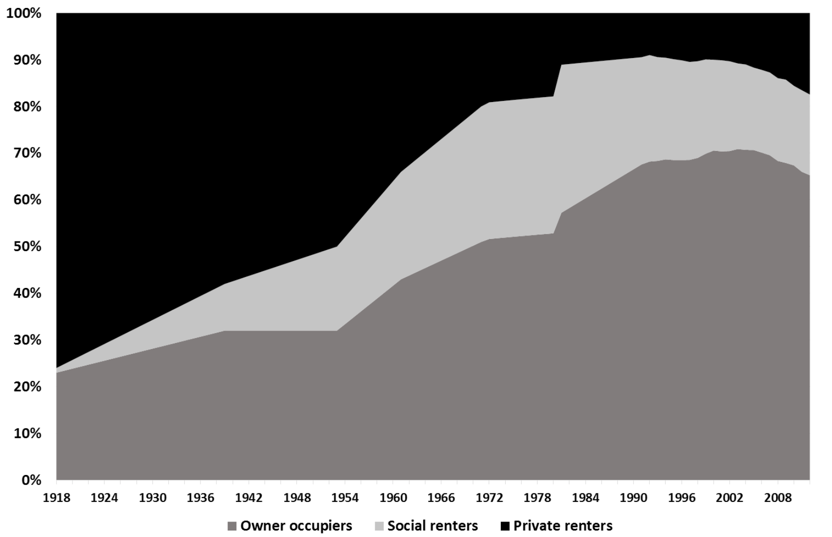
A clear example of the damage caused by classic rent controls can be seen from Britain's experience. Rent control was first introduced during wartime (1915). Far from a temporary measure, however, rent controls in some form or another were maintained right through to 1989. In the 1920s landlords were depicted as 'bloodsuckers, profiteers and despots' (Kemp 2004) and, following slight relaxations, the Rent Act 1939 reintroduced full rent control to virtually all rented housing.

By the 1950s rents were fixed either by the 1915 or 1939 acts, whilst tenants could not legally be required to leave. This left many landlords with little incentive to maintain their properties. Yet for tenants there was every incentive to remain in their properties given the cheap rents (even when their economic or family circumstances may have made it desirable for them to move on). This was a direct cause of the behaviour of the infamous landlord Peter Rachman, who would use intimidation, noise and neglect of the upkeep of his accommodation in order to attempt to drive tenants out of properties he wished to sell (Bartholomew 2004). By incentivising tenants to leave, he could sell the property 'with vacant possession'. Unsurprisingly, the amount of rentable accommodation collapsed under rent control.

There were various small changes to the regulations in the post-war period. In 1965 Labour's Rent Act introduced regulated tenancies (with long-term security of tenure) and 'fair rents' assessed by independent officers. These 'fair rents' were based on the characteristics of the property. The rent officers had to explicitly ignore the scarcity of comparable accommodation in the area and the personal characteristics of the tenants. This exacerbated shortages by keeping rents below market levels in areas where there was a scarcity of property in the first place.

The system was eventually deregulated in 1989. The private rented sector had collapsed from close to nine-tenths of the housing stock at the start of the 20^{th} century to close to one-tenth by the late 1980s (Coleman 1988). This trend can be seen in Figure 2.

Figure 2: Trends in tenure (proportion of total households)



Source: Communities and Local Government (2013).

Though this is likely in part to have been due to rising demand for owner occupation, the advantages in the tax system for mortgage home-ownership and the huge expansion of social housing after World War II, it is striking that after deregulation in 1989, since when new private lettings have been assured or assured shorthold tenancies rather than regulated or controlled tenancies, the private rented sector has rebounded. In 2013 it comprised 16.5 per cent of the housing stock. In the British case, rent controls are therefore associated with a collapse in the privately rented market, which has only recently in part been reversed since liberalisation.

Similar case studies of the negative effects of rent control on the quantity of controlled private rented accommodation have been found in Israel (Werczberger 1988) and Vienna (Hayek 1957). Friedman and Stigler (1946) perhaps outlined the clearest example when examining San Francisco. In 1906 (when there was a free market in rents), they found, 'the San Francisco Chronicle listed three "houses for sale" for every 10 "houses or apartments for rent".

In 1946, under rent control, about 730 ‘houses for sale’ were listed for every 10 ‘houses or apartments for rent’.

Whilst theoretically rent controls could lead to an increase in the supply of low-quality property for poor people, due to deterioration of higher quality properties, most of the literature in this area agrees that rent controls reduce the incentive to build by holding down the potential profits from development – and, coupled with the other regulations associated with rent control, increase the cost of capital for investors. This sometimes led to conversion of existing rentable properties to individually owned flats or office space, thus reducing the supply of rentable accommodation further (Mengle 1985).

The empirical evidence on the effects of controls on the stock of rentable housing is unambiguously negative. Two studies on Massachusetts, for example, found that the share of renter-occupied private units in the total housing stock in Cambridge fell from 75 per cent in 1970 to 66 per cent in 1980 under rent control, whilst in Boston the end of rent control increased the probability that a unit would be a rental unit by 6 percentage points (Navarro 1985; Sims 2007).

Quality and extent of disrepair

Economic theory would also suggest that crude first generation rent controls, where rents are held below market rates over a sustained period of time, would lead to a deterioration in the quality of the rental property (Kutty 1996). After all, there is little incentive for a landlord to maintain a high quality property if it is let below its market price. One might expect them to allow the quality of property to deteriorate to compensate for the lower rent. This prediction is more difficult to test empirically because of the compensatory impact of self-maintenance by tenants and other regulations which are sometimes implemented to protect tenants against maintenance failure. But there is some strong evidence that the predicted effect holds. Research on New York’s old rent control system, for example, found that there was almost a 9 per cent higher probability of an older or smaller building being in unsound condition in Manhattan if it was in the rent controlled sector (Gyourko and Linneman 1988).

Misallocation

The under-supply of rentable properties is a key consequence of rents being held below market rates over a period of time. But any analysis in this area is not complete without considering the cost of the misallocation of property. In the absence of a price mechanism to allocate the rental property to those who value it highest, the allocation of property becomes economically inefficient.

Glaeser and Luttmer (1997) outline three mechanisms through which rent controls impose economic costs as a result of the misallocation of resources. Firstly, they can distort the relative prices of renting accommodation so that, for example, the cost of luxury accommodation is reduced to a greater extent than poor quality accommodation. Secondly, the methods used to allocate apartments, given the excess demand when rents are held below market rates, can be inefficient. Because of the potential economic gain associated with securing a property at below market rents, tenants end up searching longer for accommodation, which has an economic opportunity cost. Finally, rents below market levels create significant moving costs and incentives for tenants to stay for longer in properties than they might otherwise have chosen to because of changing tastes, demands or circumstances over time. In particular, under rent control there is less incentive for families to reduce their accommodation demands, therefore exacerbating the shortage of properties for others.

These misallocation effects are significant. For example, Glaeser and Luttmer (2003) find that 21 per cent of rent-controlled tenants in New York live in properties with more rooms or fewer rooms than they would rent in a free market. Those living in rent-controlled accommodation are found to be much less mobile than those in non-controlled accommodation (Gyourko and Linneman 1989; Nagy 1995). And more recent analysis even shows that those in rent controlled sectors are willing to endure much longer commutes to work (Krol and Svorny 2005), suggesting – as theory would predict – that charging below market rents creates a lock-in effect.

Other considerations

'First-generation' rent controls were often justified as being pro-poor measures, to make renting 'more affordable' and to prevent segregation of rich and poor families. Yet these arguments do not stand up to scrutiny. How these things play out depends entirely on how property is allocated in the absence of the price mechanism. There is simply no guarantee that the people who will obtain the benefit of the below-market rent will be poor, and some evidence from Boston and New York suggests the effects were not well-targeted (Sims 2007; Ault and Saba 1990). In fact, with rent control, landlords have greater incentives to search for tenants who will make their properties more attractive in other ways. This might lead to a pro-rich bias, as landlords seek tenants considered 'easier' to deal with. The queuing effects created by below-market rents may also lead to cronyism, extensive use of existing contacts, or maybe discrimination, side payments and bribes, which could actually worsen segregation between rich and poor (Glaeser 2002). In the UK system, students were favoured because they were less likely to abuse security of tenure provisions. Furthermore, arrangements that also provided board (food) were not included and thus the provision of such services was artificially encouraged.

Second generation rent controls

Introduction and theory

Unsurprisingly, few commentators now advocate the sort of crude controls that were seen in Britain and elsewhere (though some do: see Dorling 2014). Instead there are calls for ‘second-generation’ rent controls, in particular in the form of ‘tenancy rent controls’.

Second-generation controls encompass a wide range of different regulatory requirements. They most often entail rules governing increases in rents (rather than the level of rents). Increases may be linked to a rate of inflation or to the average increase in market rents for a particular locality, and they often involve allowing rent increases under certain conditions where it is necessary for landlords to pass through cost increases or undertake investment in a property.

The most recent mutation, as advocated by the Labour Party in the United Kingdom, is for what could be referred to as ‘tenancy rent controls’. These have all the features of second generation rent controls but allow the landlord complete freedom to adjust rents between tenancies. As such, some have suggested that they are not really rent controls at all, but could be better described as longer-term fixed-price contracts.

Since rents would be free to adjust between tenancies, they do not have the same consequences as first-generation rent controls. Ultimately, rents will be determined by supply and demand, at least at the beginning of a tenancy. This means that they do not lead to the progressively worsening outcomes seen with ‘first-generation’ rent controls over time (Arnott 2003). Instead it is best to think of them as protection for tenants against the possibility of large, unforeseen rent increases within a tenancy. This explains why tenancy rent controls are often accompanied by security of tenure arrangements.

Allowing rents to diverge from market rent levels even within tenancies, however, is likely to have distortionary effects on the rental property market. To examine why this would be the case, the remainder of this paper sets out the proposals for tenancy rent controls put forward by the Labour Party as a means of analysing the sorts of incentives they create.

UK proposals for tenancy rent controls

In May 2014, Ed Miliband delivered a speech in which he promised that a future Labour government would institute a policy of ‘tenancy rent control’. The declared aims were to make it more difficult for landlords to evict tenants by hugely increasing rents (so-called economic eviction) and to ease the ‘cost of living crisis’.

Earlier, David Lammy MP had pressed for rent controls along German lines. There, rents are free to be set according to market conditions between tenancies, but tenants enjoy indefinite tenancies during which rents can only be increased by a maximum of 20 per cent in any three-year period (Lammy 2014). Too many renters in London, according to Lammy, were faced with uncertain and unaffordable rents within the current framework. The homeless charity Shelter and other campaigning organisations such as Generation Rent have expressed similar concerns about the uncertainty of renting, and have thus called for moves to make tenancies more secure. Indeed, the Secretary of State for the Department of Communities and Local Government, Eric Pickles MP, whilst not proposing statutory implementation, had proposed to work with the industry to draw up more secure ‘model contracts’ with inflation-linked rents – suggesting that even the coalition government had begun thinking along these lines (DCLG 2013).

The figures on annual rents in the UK are indeed stark. Average rent levels across the country for those in the private rented sector are equivalent to 41.1 per cent of weekly gross household income

(ONS & DCLG 2013). Even in the social rented sector (local authority and housing association homes), the figure is 29.6 per cent. This too is after taking into consideration state assistance in the form of housing benefit as part of gross weekly income, the annual bill for which now stands at £23.9 billion (DWP 2014). Excluding this benefit, the average proportion of the remaining weekly household income going on rents from private and social renters would be as much as 50.7 per cent and 40.4 per cent respectively (ONS & DCLG 2013).

London has extraordinarily high absolute rent levels. The Valuation Office Agency calculates that the median rent for two-bedroom accommodation in London is £1,387: more than double the average for England. Annual incomes in London are only 39 per cent higher.

The recent significant pick up in the property market, combined with the ongoing and well-acknowledged problems surrounding the supply of property (Cheshire 2014), means that significant increases in rents are expected in the coming years (Ball 2013).[2] This comes following a sustained real wage squeeze in the aftermath of the Great Recession.

The homeless charity Shelter has proposed that regulations for more secure tenure would be good for both tenants and landlords, particularly in difficult economic times. With over 1.3 million households in the UK now renting, Shelter's polling claims that 66 per cent of private renters would like to have the option to stay in their tenancy longer and 79 per cent would like to know that their landlord/letting agents would not be able to raise their rent above a certain rate while they were living in the property.

This is perhaps unsurprising – tenants will always value flexibility. But those in favour of longer tenancies underpinned by state legislation also claim that the sorts of assured shorthold tenancies that dominate the UK rental market are only so prevalent because

2 In the long-term house prices should reflect the discounted present value of net rent streams. Cyclical variations can arise in rents relative to house prices due to income and credit constraints.

both landlords and tenants are trapped in a market norm, from which they would both prefer to move away. Long-term contracts are held up as being more successful and it is argued that more security of tenure would be good for landlords, who would enjoy lower vacancy risk.

The perfect storm of high house-price inflation, a living standards squeeze, high housing benefit expenditure and a political campaign for more secure tenure has therefore brought attention to the issue of high rent levels.

The actual proposals put forward by the party did not go as far as, say, the rent control model seen in Germany. Rather than indefinite tenancies, Labour proposes new fixed three-year tenancies during which a landlord can evict a tenant only for breach of contract (such as arrears or anti-social behaviour) or because the landlord needs the property for their family or to sell. Whilst there would be complete freedom for landlords to set rents between tenancies, rents within tenancies would be benchmarked so that increases were linked to average increases within a locality, some measure of inflation, or both.[3] These changes would also alter the balance of power in favour of tenants, who would still be able to terminate their contract after the probationary period with one month's notice.

3 The Labour Party has asked The Royal Institute of Chartered Surveyors to review the most appropriate benchmark.

Do tenancy rent controls improve affordability or security?

Affordability

As already outlined, ‘tenancy rent controls’ allow market rents to be set according to market conditions when tenancies change. We would therefore only expect tenancy rent controls to reduce rents below market levels during a tenancy.

This means that this type of rent control cannot improve the affordability of renting except for in the case of particular tenants in the short term. The only thing tenancy rent controls can really achieve is to protect existing tenants from large rent rises within tenancies, and as such from landlord attempts to drive someone out of a tenancy by increasing rents (sometimes called ‘economic eviction’).

Instead, tenancy rent control is just likely to change the timing of the overall rent cost within a tenancy (Nagy 1997). Since landlords know they cannot adjust rents each year to fully reflect market conditions, they are likely to set rents at the start of the tenancy according to their judgement as to what they expect rents over the lifetime of the tenancy to be. In fact, if they expect that the market rent will increase by more than the average used to determine the rent control, they will front-load the rent level to compensate for their future loss. New tenants are therefore likely to face higher rents initially than they would in a free market, in order to compensate for forecast lower future rents.

Since the major effect on returns to the landlord from tenancy rent control is to merely change the timing within a tenancy then, we should not expect the same dramatic effects on investment in rental housing construction and the supply of rentable property as we had from rent control in the 20th century.

However, there may be a fall in investment in the private rented sector if tenancy rent control is viewed as a precursor to even more regulation of the private rented sector in the future. In addition, given that any form of rent control restricts the landlords' ability to manage their risks, in all probability there is likely to be either a small negative effect on investment due to an increased cost of capital and/or a small rise in the overall level of market rents to reflect the greater risk.

Security of tenure

Many people claim that tenancy rent controls are necessary in order to improve the security of tenure for tenants, which is said to have desirable economic consequences. The implicit assumption here is that there is some sort of market failure in the rental property market whereby both landlords and tenants would benefit from regulation to ensure that tenancies are more secure. The vision often painted by campaigners for this is of a young family with children who would like the security of knowing they have a guaranteed fixed-term rental contract limiting exceptional increases in rent and the threat of economic eviction. From the landlord's perspective, it is assumed that the threat of vacancy is a significant consideration, and that by changing the market norms via fixed-term contracts, this vacancy risk can be more effectively managed.

Is this justified? And to what extent do tenancy rent controls affect tenure security? In the UK there is very little evidence that tenure security is unavailable when tenants are willing to pay for it (Ball

2013). Longer-term tenancies with more stability and predictable rents do exist, but are not widely taken up. Shelter and other campaigners use evidence that tenants say they would like more security of tenure to justify their market failure arguments. But the truth would appear to be that tenants are unwilling to pay for increased security.

From a landlord's perspective, an additional problem is the asymmetric nature of the tenancy agreements that have been proposed under tenancy rent control. For example, the proposals would mean that tenants could leave a property with one month's notice whilst landlords could only evict tenants for breach of contract within the three-year period.

In a free market, with no regulated fixed-period agreements, a landlord could seek to impose penalties within a contract for early termination by the tenant to compensate him for vacancy risk (like, for example, leases in the commercial sector). Indeed, contrary to the narrative that secure tenancies dissipate vacancy risk for landlords, these types of controls actually force landlords to bear the vacancy risk – and do not allow them to use market mechanisms currently in operation when the preferences of landords and their tenants align (Ball 2013). On top of this, landlords in a secure tenancy framework would face the prospect of 'problem tenants' enjoying greater security of tenure, making the management of risk through turnover more difficult.

As has been noted, it is unclear that there is a significant security of tenure problem in the UK. Although survey data do suggest people would like more secure arrangements, not only do they not seem willing to pay for it, but the fact that the private rental market is dominated by the young, mobile, and childless demographic groups suggest that security of tenure might not be a huge problem in practice (see Table 1). Not only is there little evidence that private renting tenants are unhappy with their accommodation per se (overall satisfaction rates were at 91.2 per cent in 2011/12[4]) or that

4 English Housing Survey

many people move involuntarily, but there is also little evidence that even parents with children are substantially less mobile than other renters (Ball 2013). For example, the English Housing Survey shows 18.9 per cent of households with dependent children moved within the last year, compared to 23.7 per cent without. At least part of the reason for this is because many rent as a stepping-stone to owner occupation - 24.8 per cent of new owner occupiers over the past three years were households with dependent children who were previously in rented accommodation.

Table 1: Economic and demographic characteristics of private market renters

Age	**Proportion**
16-34	53.0%
35-54	35.6%
55+	11.4%
Marital status	**Proportion**
Single	32.1%
Married	27.0%
Cohabiting	23.5%
Other	17.4%
Numer of persons in household	**Proportion**
One	25.1%
Two	37.7%
Three	19.4%
Four	10.9%
5+	5.1%
Household type	**Proportion**
No dependent children	65.7%
Dependent children	34.3%
Length of residence	**Proportion**
< 1 year	35.4%
1-3 years	36.7%
3-5 years	13.8%
5+ years	14.2%

Source: English Housing Survey (2013, Table FA3101, S418)

There are undoubtedly some renters who would prefer more secure arrangements, however. To the extent that tenancy rent controls and fixed tenancies tilt the balance in favour of tenants, they do help insure against the risk of 'economic eviction' by landlords who force tenants to leave by implementing significant rent increases. To a certain extent this effect will likely be offset by landlords being more punitive in the enforcement of contracts, but provided tenants stick to their contract, security of tenure will be stronger than in an uncontrolled market (Arnott 2003). However, it should not be assumed that tenants will not have to pay for this benefit through higher rents.[5]

The existence of controls may also affect decisions of landlords and tenants in the allocation of rental properties, both prior to and within a tenancy. Since landlords with properties who expect the rent controls to bind are likely to front-load their rent levels, landlords face an incentive to seek out tenants who are likely to be mobile - such as students or young people (Arnott 2003). This is because the early years of the tenancy are when the landlord makes the highest profit.

Within tenancies landlords are likely to have an incentive to speed up a tenant's departure the longer the tenant stays in the property, if the rent control binds. This might express itself as being less cooperative with the tenant as time goes on, or by being less willing to undertake maintenance. The opposite incentives apply for the tenant. If a tenant's situation changes, for example as a result of a job offer, he is less likely – all else given – to move given the benefit of a lower real rent later in the existing tenancy relative to starting a new tenancy. This might mean either a longer commute or a reduced likelihood of the tenant taking the job. Tenancy rent controls therefore benefit less mobile households to the detriment of more

5 There is a technical point here too. Tenants obtain the benefit of being able to break the tenancy whilst landlords cannot do so. This is not just a question of convenience or the loss of potential business opportunities. Tenants get the benefit of market rents falling (relative to the formula used to determine rents within a tenancy) but do not bear the cost of rents rising (because rent increases are restricted). This creates what is known as an 'option value' in favour of the tenant. It would normally be expected that average starting rents would rise in response to this.

mobile households and are likely to have a negative effect in terms of economic efficiency unless landlords are effective at anticipating which tenants are likely to be mobile.

Other considerations

There are two further considerations. As with rent levels, the existence of tenancy rent controls and contracts is likely to change the timing of when maintenance occurs. Landlords are much more likely to undertake maintenance between tenancies than within them. This is particularly true if market rents increase more quickly than the landlord expected prior to the tenancy agreement. Tenants are also likely to have to undertake more self-maintenance on a property than they would in an uncontrolled market (Olsen 1988).

Secondly, ‘first generation’ rent controls were ultimately unsustainable because the negative effects were clear and became progressively worse the longer rents were held below market rates. This is not the case with tenancy rent controls. They are likely to become very difficult to reverse as tenant lobby groups tend to be more powerful than the losers from the policy – small-scale landlords, who find it more difficult to manage risk, and young, mobile, households. With tenancy rent control inevitably comes an expansion of bureaucracy too – and this bureaucracy will also have a vested interest in the maintenance of the policy. Under the policy, for example, a body will be required to attempt to calculate average rent increases, and presumably an enhanced arbitration process will be necessary for settling disputes over whether attempts to evict are justified.

But don’t rent controls work in Germany?

Many advocates of tenancy rent controls dismiss the above arguments by suggesting that similar policies in other countries – notably Germany (generally regarded as a country in which it is very favourable to rent) – provide evidence that controls are not particularly detrimental to the health of the rental market (Lammy 2014). In Germany, rents are set by the market initially but then can only be raised within tenancies according to inflation or increases in the landlord’s costs. Rents cannot increase by more than 20 per cent in any three-year period. Tenants have indefinite tenancies and can only be evicted for non-payment of rent (over a number of months), or because of breach of contract arising from damage to the property, for unauthorised subletting, or to allow the landlord or a member of his family to live in the home or to sell the home.

Attributing the success of the German rental market to ‘tenancy rent controls’, however, ignores huge structural differences in the housing market more broadly compared with the UK. These structural factors, in particular the fact that there is a much more elastic supply response to changes in demand for housing in Germany, mean that both rents and house prices are much lower - relative to income – than in the UK (Niemietz 2014). Figure 3 below shows that the affordability of German housing has continually improved since 1980, whereas for the United Kingdom the reverse is true. This is largely caused by significantly higher levels of dwelling completion per 10,000 inhabitants compared with the UK and a more liberal planning regime (Niemietz 2014; Ball 2013). Unsurprisingly then, rent levels are lower. Table 2 shows rent levels in UK and German cities according to the cost-of-living comparison website Numbeo.

The structural differences which make rent levels much higher in UK cities make every other consideration relatively trivial – it is unsurprising that the effects of tenancy rent controls in Germany look benign when other factors are making renting much more affordable compared with the UK.

Figure 3: House price to average income ratio in Germany and UK

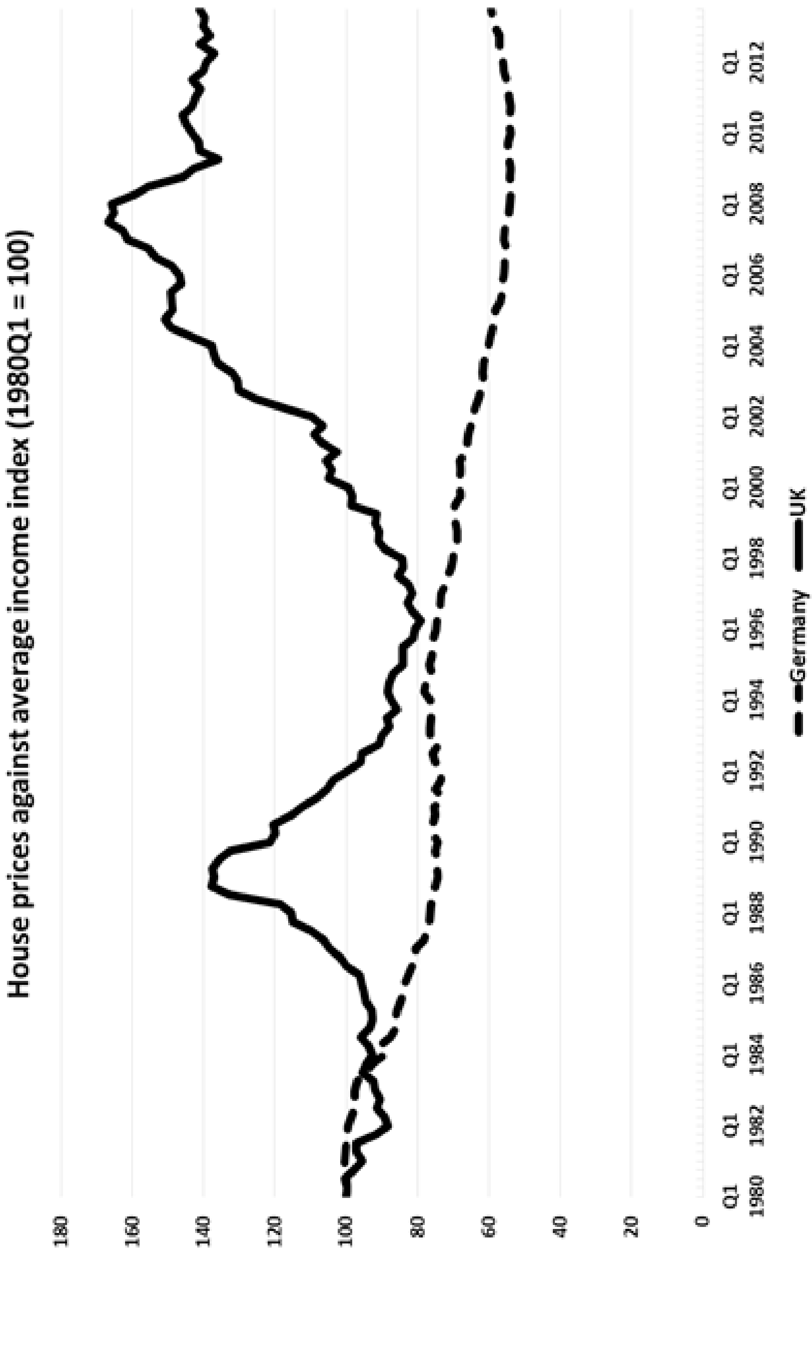


Table 2: Comparison of rent levels in UK and German cities, 2014

	London	Munich	Manchester	Frankfurt	Birmingham	Berlin	Oxford	Hamburg
Rent Per Month								
Apartment (1 bedroom) in City Centre	£1,502.28	£699.54	£636.22	£530.63	£632.14	£477.11	£987.50	£526.83
Apartment (1 bedroom) Outside of Centre	£945.41	£558.66	£468.33	£351.79	£432.86	£344.20	£768.00	£407.30
Apartment (3 bedrooms) in City Centre	£2,837.50	£1,395.04	£1,155.00	£1,061.48	£1,150.00	£992.74	£1,638.80	£1,381.71
Apartment (3 bedrooms) Outside of Centre	£1,720.18	£997.13	£836.00	£762.44	£700.00	£698.89	£1,283.33	£717.85
Average Monthly Disposable Salary (After Tax)	£2,100.08	£1,880.02	£1,253.48	£2,518.04	£1,755.62	£1,458.67	£1,700.00	£1,660.30

Source: Numbeo - Property Prices Comparison between Berlin and London

That said, some recent studies have suggested problems are developing in the German rental property market in terms of low levels of investment in new development, with rents rising as a result (Ball 2013). In fact, in many cases where long-term contracts and tenancy rent controls operate, the rental markets suffer from low levels of investment, which has led to other policy responses such as more support for new development, allowances and tax breaks. Any comparison must take into account these different frameworks.

The big difference though between the UK and German rental markets is not the existence of tenancy rent controls – which, as has been explained, can have detrimental consequences in terms of economic efficiency and the creation of perverse incentives – but, instead, much better use of land and more housing availability enabling more affordable rents. Tenancy rent controls by construction cannot improve affordability. Their use entails a trade-off between providing more secure tenure for existing tenants against the economic inefficiency caused by reduced labour mobility, misallocation and the potential for lower investment in the rentable housing stock.

Conclusion

Rent control is back on the agenda, particularly in the United Kingdom, because of the cost-of-living squeeze, structurally high rent levels and a large housing benefit bill. The sort of crude controls of nominal rents implemented and maintained by many western countries following periods of war in the 20th century have long been abandoned as a policy ambition. These are recognised to have devastating consequences on the supply and maintenance of rentable property, whilst having large economic costs associated with resource misallocation and reduced labour mobility.

Instead, many policymakers now advocate a variation of ‘second generation’ rent controls, known as tenancy rent controls, in which landlords are free to adjust rent levels between tenancies but are restricted within them. In the UK, for example, the Labour Party wants fixed three-year tenancies where rents can only be raised by an as yet unspecified ‘average’ rental increase.

Since rents under this framework adjust between tenancies, this sort of rent control does nothing to improve affordability. In fact, it can increase market rents. Instead tenancy rent control makes tenancies more secure for tenants by eliminating the risk of ‘economic eviction’ within tenancies. Whilst this can be advantageous for relatively immobile sitting tenant households, this extra security comes at the expense of reduced economic efficiency, the creation of perverse incentives for landlords and tenants, and at the expense of ‘outsiders’ to the rental property market.

These interventions are said to be justified because many tenants outline in surveys that they want more security. Yet there is little evidence in a UK context that the market is failing to provide what tenants want and are willing to pay for. Indeed, by reducing landlords' ability to manage risks and by alluding to the possibility of further regulation, tenancy rent controls may lead to less investment in and supply of rentable accommodation.

As such, though not as damaging as first-generation rent controls, it is unlikely that rent controls will achieve the desired aims of improved affordability and substantial security for tenants. The real problem here is the affordability of housing and renting. A more flexible supply enabled by a liberalisation of planning is the type of policy we should be following Germany in implementing, rather than imposing new conditions on a market which has been a relative success story since liberalisation in 1989.

Indeed, planning liberalisation would clearly be a welfare enhancing policy, whilst tenancy rent controls would not. As with most price ceilings, if they are effective in reducing tenants' costs and/or increasing security (which is highly unlikely) they will do a great deal of damage. If they do not do much damage, they will not reduce costs or increase tenant security noticeably. Of course, these proposed price ceilings – as with more radical measures implemented in the 20th century - do provide a readily observable policy to show that politicians are 'acting' on the concerns of interest groups. Any negative consequences, meanwhile, are more likely to be opaque. As always with policies like these, they are more likely to be in the interests of those who propose them than in the interests of those whom they are purported to benefit.

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