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# RENT CONTROLS

How they damage the housing market,  
the economy and society

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## About the author

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# Summary

Rent controls are now being discussed in cities like Berlin, London, and New York. Sweden has had rent controls since 1942. There are at least nine reasons why the Swedish experience should serve as a cautionary example for other countries.

1. Rent controls have caused housing shortages and queues. 93 percent of Swedes live in municipalities with housing deficits. Upon relocation, only 0.5 percent of primary tenants in central Stockholm return their apartments to the housing agency. As a result, the average queue for a rental apartment in the capital is 11.3 years – reaching 30 years for heavily subsidised apartments.
2. Regulating rents skews incentives, which has led to a rapid conversion of rental apartments into co-op flats. The regulation also diverts excess demand into the property market, raising prices and incentivising renters to buy out their apartments for sub-market rates. As a result, the share of rental accommodation in Stockholm has fallen by a third since 1990 – contributing to high household indebtedness.
3. Rent controls have channelled excess demand precipitated by low primary rents into the subletting market, pushing up rents for secondary tenants. In Stockholm, these tenants pay rents twice as high as the primary tenants – a cost often borne by those with low social capital.
4. The regulation has enabled a black market for rental contracts with an estimated annual turnover of 110 million euros. One in five young tenants in Stockholm admit to having paid illegally for a rental contract. In 2014, Sweden saw a wave of homicides of individuals linked to the illegal contract trade.

5. Rent controls have caused an inefficient use of the existing stock of apartments. 90 percent of the estimated one-billion-euro rent-regulation-induced welfare loss stems from apartments not being allocated according to renters' willingness to pay – which causes long commutes for families with children while individuals occupy large apartments in attractive areas.
6. For companies, the regulation has led to recruitment difficulties. Many growing companies in knowledge-intensive industries report employee housing as a major obstacle to recruiting qualified foreign workers. In one survey, a fifth of companies claimed that housing shortages made recruitment more difficult during the previous year.
7. Rent controls have caused social segregation between market insiders, who are more likely to be highly educated individuals with good connections, and outsiders, often immigrants or young people. As a result, the latter tend to live in unattractive suburbs – areas with extraordinarily high levels of concentrated welfare dependency and unemployment.
8. The system fails to achieve its primary policy aim: egalitarian economic outcomes. Large apartments in the most attractive housing sub-markets receive the greatest indirect subsidies. In Stockholm, the households occupying rental apartments larger than 180 square metres had an average income equivalent to the top 100<sup>th</sup> income percentile.
9. Rent controls have led to sub-optimally high standards of housing. Since rents may only be raised when apartment standards improve, landlords are incentivised to undertake expensive renovations. Consequently, the market cannot cater to renters who value living in city centres but who are unable to afford higher housing standards. This increases economic segregation.

# Introduction

Many regions with booming housing markets are looking to rent controls to combat spiking rent levels. The Mayor of London has called for new powers to impose rent controls in the city, and the Labour Party's national manifesto contains a specific pledge for the policy.<sup>1</sup> Parisian authorities have also "reintroduced rent controls in a bid to get a grip on the spiralling cost of living", and this summer "the New York state legislature ... agreed on a package of sweeping tenant protections and rent regulations that would be the biggest rewrite of tenant law in decades".<sup>2</sup> US Democratic presidential candidate Bernie Sanders echoed these sentiments succinctly, tweeting: "We need national rent control."<sup>3</sup>

Berlin and California have also introduced or are considering introducing rent controls. The governing coalition in Berlin has introduced legislation capping city-wide rents.<sup>4</sup> The city has a high share of rental apartments, but due to high demand, rents have grown at far higher pace than the average disposable income.<sup>5</sup> "With the new law", argues the city's housing senator Karin Lompscher, "we want to put a stop to the serious rent increase in recent years and calm the overheated rental market".<sup>6</sup>

California lawmakers are reacting to a state-wide housing crisis that has fuelled a wave of homelessness. "We cannot build our way out of this crisis fast enough" says state senator Nancy Skinner (D-Berkeley), "and meanwhile, we have more and more working Californians, families, regular

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1 Elgot, 2019; Labour Party, 2019, p 79.

2 AFP, 2019; Goldman, 2019.

3 Sanders, 2019.

4 €7.97 per square meter per month, or €6.03 for pre-1918 structures. (Dillion, 2019).

5 Goncalves Raposo, 2019.

6 Forrest, 2019.

people, who are being displaced from their residences.”<sup>7</sup> A proposed bill (AB 1482) would cap annual rent hikes at five percent plus inflation until 2030.<sup>8</sup> This is thought to “provide meaningful protection” against “the most egregious rent increases” in the state.<sup>9</sup>

Sweden has had some form of rent controls since World War II. Introduced under an egalitarian rhetoric echoing that of contemporary advocates, the Swedish experience shows how rent regulation has many unintended consequences. Therefore, it can serve as a warning for other countries tempted to pursue the same policy path. This report details the many economic and social problems caused by the Swedish system of rent controls.

In brief, the Swedish rental market is dysfunctional. It has hampered economic development and social mobility. It has caused housing shortages in cities by reducing the stock of apartments and by impeding the efficient utilisation of that stock. This has diminished Swedish companies’ ability to recruit and limited Sweden’s overall economic output.

These economic costs come without significant distributional or social benefit. In fact, rent controls have contributed to social segregation by favouring insiders with high social capital at the expense of young, often foreign-born, outsiders. These negative consequences are becoming increasingly clear as the demand for housing grows due to rising incomes and increased urbanisation.

Rent controls not only impose immense economic costs but also fail to achieve their primary policy aims and foster political dysfunction along the way. The Swedish example can serve as a case study in how politicians acting with the best of intentions can produce results at odds with their goals.

Although Sweden’s rental market has been subject to criticism from academics, think tanks, and institutions like the European Commission, the OECD and the IMF, it remains a sacred cow in Swedish politics.<sup>10</sup> Once rent controls are established, challenging the clearly defined interest group constituted by current renters to benefit the broad, undetermined, and comparatively unmotivated common interest has proven to be a

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7 Chandler, 2019.

8 DW, 2019.

9 Chandler, 2019.

10 OECD, 2012; European Commission, 2014; Ulku et al, 2014.

political taboo. This report should serve as a cautionary tale for those wishing to regulate rents.

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## Rent controls in Sweden

Sweden capped rents in 1942 as a temporary wartime measure. Now, the system is indirect – i.e., there are no longer any legally inscribed caps on rents or ceilings on rent increases. Still, the policy has *de facto* binding effect in all attractive housing submarkets in medium-sized and large cities.

The Swedish model centres around two ideas:

- Rents are set with reference to the apartment's utility value, as prescribed by Rent Act (1970).<sup>11</sup> The rent should be reasonable, thus not significantly higher than rents paid for comparable apartments. This assessment is based partly on the characteristics of the apartment, with reference to the size and standard, and partly on the basis of the building's and the area's characteristics.
- Rents are collectively negotiated by representatives of the tenants (the Swedish Union of Tenants) and the landlords. This is stipulated in the Rental Negotiation Act (1978) and is believed, at least by the Union of Tenants, to “[provide] the prerequisites for fair rents”.<sup>12</sup>

Although individual negotiations between tenants and landlords are allowed, there is in practice no freedom of contract since the tenant can at any time appeal his rent to the Rent and Tenancy Tribunal – which works to ensure that rents do not exceed those of comparable apartments.<sup>13</sup> The Union of

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11 12 chapter, 55§ Jordabalken (JB, 1970:994).

12 Hyresförhandlingslagen, Swedish Code of Statutes 1978:304; Swedish Union of Tenants, 2016, p 28.

13 12 chapter 19 § Jordabalken (JB, 1970:994) ; Swedish translation: *Hyresnämnden*; N.b. the renter does not need to be subject to a rent-hike to appeal his rent. However this is when (for obvious reasons) the appeals process is most commonly initiated.

Tenants has a uniquely powerful bargaining position. And what is more, they lack any real incentive to accept any rent increase, which is why the landlords have little choice but accept their bid.

This is so because if the two parties fail to reach an agreement, the alternatives are, for the landlord, almost always worse, since it either forces him to withdraw the scheduled annual rent increase, or to test the rent in the Rent and Tenancy Tribunal. The latter is a time-consuming process, and most often results in an outcome mirroring the Union of Tenants' initial offer. The inequality of bargaining power is reflected in the fact that Sweden has seen inflation-adjusted rents fall during recent years.<sup>14</sup>

The regulated rental market co-exists with a complementary system of "presumption rents".<sup>15</sup> Introduced in 2006, the system grants landlords of newly constructed apartments the right to negotiate market-oriented rents with the Union of Tenants. Landlords are permitted to charge these elevated rents for 15 years to recoup their investments. However, studies show that these presumption rents apply to "far from all new production".<sup>16</sup>

The original motivation behind the Swedish system of soft rent controls was to ensure that regulated utility value rents reflected market rents in a state of long-term equilibrium. This in turn would insulate renters from short-term price fluctuations.<sup>17</sup> Until 2003, when there was some balance on the Swedish rental market at large, this goal was at least superficially achieved.<sup>18</sup> Now, in a market shaped by urbanisation and population growth, the Swedish system of soft rent regulation produces economic inefficiencies and suboptimal social outcomes.

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14 Ohlsson, 2017.

15 12 kap. 55 c § JB; in Swedish: *Presumtionshyror*.

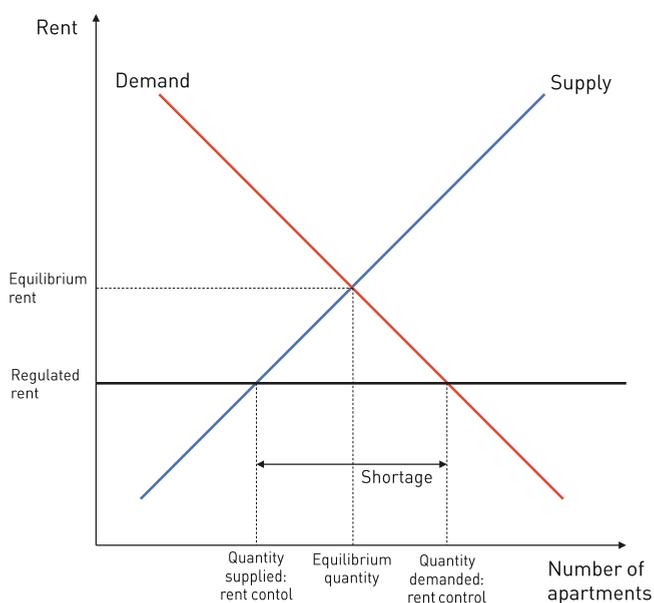
16 National Board of Housing, Building and Planning, 2013, p 6: "For example, a study covering all new buildings from the date of introduction of the presumption rental system shows that the most common is that rents are negotiated in a traditional way, i.e., within the framework of the utility value system (55 percent of the new buildings surveyed), while presumption rent was used in 32 percent of the cases."; Jordabalk (1970:994), 12 kap. 55 c § JB; Government Office of Sweden, 2017, p 224: "The lack of interest in presumption rents may partly be due to increased uncertainty regarding the possibility of bringing about rent increases in current contracts. The negotiation system can be said to have shown a norm for successful rent increases, which can be experienced as uncertain if it follows with presumption agreements."

17 Kopsch, 2019a, p 11; the system was also intended to protect renters against exorbitant rent hikes as an eviction strategy – giving them security of tenure.

18 National Board of Housing, Building and Planning, 2012, p 8: According to the National Board of Housing, Building and Planning's definition, the housing crisis has only sprung up this decade – and as late as 2003 there was relative balance in the Swedish rental market.

# Consequences of rent controls

## 1) Housing shortages and queues



**Figure 1. The rental market with a rental ceiling below the market equilibrium.**

Direct rent controls are synonymous with price ceilings on rents. In practice, the Swedish model also has binding effect on the landlord's ability to set market rents. As a result, regulated rents are lower than equilibrium rents – those that would prevail on an unregulated market. The outcomes are illustrated in figure 1: if the rent ceiling is below the equilibrium rent, the quantity of housing demanded (“quantity supplied: rent control”) will exceed the quantity of housing offered (“quantity demanded: rent control”). This

means housing shortages. Thus, rent control causes the same problems as all other price controls, which is why Lindbäck (2016) writes:

Economists have often found amusement in that it took a decade of queueing to buy a Trabant car in East Germany during the communist era. Today in Stockholm, the waiting time to get a rental apartment via the municipal housing queue is approximately the same length.

The empirical evidence confirms this model: Swedish rent controls have caused excess demand in the most attractive housing markets.<sup>19</sup> In central Stockholm, where the problems are the most severe, equilibrium rents are by some estimates 70 percent higher than regulated rents. This results in a 27,000-apartment shortfall in the city.<sup>20</sup> In Gothenburg, equilibrium rents are 25 percent higher than regulated rents, resulting in a 7,000-apartment shortfall.<sup>21</sup>

The problem is not limited to the major cities. As many as 93 percent of Swedes live in municipalities with housing shortages.<sup>22</sup> Only four percent live in municipalities with housing surpluses.<sup>23</sup> As a point of comparison, only three percent of Swedish municipalities reported a housing deficit in 1994, and 70 percent of municipalities reported surpluses.<sup>24</sup>

The demand for rental apartments is immense. When the price mechanism is not allowed to create equilibrium in the housing market, apartments

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19 Andersson & Söderberg, 2002, p 621: "In the event of a complete winding up of rent control, welfare gains can be achieved through the turnover of tenants so that those outside the stock with a high willingness to pay replace those who own a rental apartment but have low willingness to pay."; Ministry of Finance, 2015, p 72; Lindblad, 2010, p 12.

20 Donner, Englund & Persson, 2017, p 4; Donner, Englund & Persson, 2017, p 25: The Swedish Fiscal Policy Council "used data from the unregulated market for cooperative apartments to study how rents would change if the rent control were to be lifted in metropolitan Stockholm." Their "results indicate that the rent increase in the wealthy central-city neighbourhoods would increase by around 30–70 percent. By contrast most suburban neighbourhoods would have rent increases of 20-40 percent – and some neighbourhoods may even experience rent decreases."; National Board of Housing, Building and Planning, 2013, p 10: This assumes supply and demand elasticities for the Swedish rental apartment market of 0.2 and –0.5 respectively, such that a 10 percent rent hike leads to a 2 percent increase in the supply of apartments and a 5 percent fall in the demand for apartments; the numbers used are true as of 2013.

21 Söderberg, 2013, p 10.

22 National Board of Housing, Building and Planning, 2018a, p 9.

23 National Board of Housing, Building and Planning, 2018a, p 9.

24 Söderberg, 2013, p 10.

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need to be allocated in some other way – for example via a queue system. As of October 2019, 670,000 people are listed in the Stockholm housing queue, of which just over 100,000 are actively looking for housing.<sup>25</sup> The queue grew by seven percent, or 40,000 person, year-on-year.<sup>26</sup> To put that in perspective, the Stockholm Housing Agency only mediates around ten thousand apartments in Stockholm per year.<sup>27</sup>

A common misperception is that an apartment no longer needed by the tenant is reliably made available to the next person in the local housing queue. However, few apartments in popular submarkets are actually allocated this way. Tenants recognise the value of their contracts, and few are willing to return them to the housing agencies. Instead, rental contracts are exchanged for other apartments, transferred within one's family or sold on the black market. Many contracts are also mediated directly by the property owners. According to one study, only half a percent of primary rental contracts in central Stockholm are returned to the Stockholm Housing Agency. For the greater Stockholm region, the number is around five percent.<sup>28</sup>

As a result, the average housing queue for a Stockholm-based rental apartment has reached 11.3 years, up from 5.7 years in 2010.<sup>29</sup> On the Stockholm Housing Agency's website, there is, as of 29<sup>th</sup> August 2019, one apartment listed in Norrmalm – a borough in central Stockholm. For this two-bedroom flat, rent is set at 1,130 euros per month.<sup>30</sup> The person first in line for this apartment signed up in November 1989.<sup>31</sup> Since there is an 18-year age limit on entering the housing queue, it is effectively impossible for young people to obtain a centrally located rental apartment through proper means. In the wealthy district of Östermalm, the Stockholm Housing Agency mediates so few apartments that it has ceased reporting on the length of the rental queue altogether.<sup>32</sup>

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25 Stockholm Housing Agency, 2019b.

26 Hellekant, 2019. The Confederation of Swedish Enterprise estimates the pent-up housing demand, or accumulated housing shortage, to be 121, 100 homes in Stockholm alone (Frycklund, 2019, p 12).

27 Stockholm Housing Agency, 2019b.

28 Property Owners, 2006.

29 Hellekant, 2019; Hellekant, 2018.

30 12,143 Swedish kronor.

31 Stockholm Housing Agency, 2019a.

32 Eklund, 2014, pp 18-19. In the similarly wealthy district Vasastan, the queue is thought to be in excess of 20 years. The average queue for a rental contract in Stockholm is estimated at 16 years by Fiscal Policy Council Report 2019.

## 2) Conversions

Sweden also has a traditional property market with tenant-owned apartments, operated via a system of cooperative housing associations (co-ops).<sup>33</sup> Buying an owner-occupied apartment means buying a share in a housing co-op – granting one the right to live in co-operative flat. Co-op flats exist as an imperfect substitute to rental apartments – requiring an upfront capital investment. However, as opposed to the controlled rental market, co-op flats are bought and sold on an unregulated market.

The fact that the rental market is price-controlled while the market for owner-occupied apartments is not has the effect that both current renters and landlords find it lucrative to convert their apartments into co-op flats.<sup>34</sup> This requires a two-thirds majority among building tenants, in addition to the consent of the landlord. Converting a rental apartment building into a housing cooperative allows both parties to share the surplus that arises when an apartment is transferred to a price-governed market. Typically, the current renter only pays 70–75 percent of the flat's market value when buying it out. This makes for a potentially significant profit should the new owner wish to sell.<sup>35</sup> As a result, the share of rental accommodation in Stockholm has fallen by a third since 1990 (from 54 to 36 percent of the total housing market).<sup>36</sup> Adding to this trend is the fact that rent controls usually make it more profitable to build housing co-ops rather than rented apartments.

A fall in the share of rental apartments means that households may feel forced into the co-op market despite preferring to rent. Many of these unwilling households take on high debt burdens. By channelling excess demand into the co-op flat market, rent controls have “contributed to a dramatic price increase in co-op shares”.<sup>37</sup> The resulting excessive

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33 In Swedish: Bostadsrättsföreningar.

34 This pattern is found by Diamond, McQuade & Qian (2019) in San Francisco. They suggest that: “In the long run, landlords’ substitution toward owner-occupied and newly constructed rental housing not only lowered the supply of rental housing in the city, but also shifted the city’s housing supply towards less affordable types of housing that likely cater to the tastes of higher income individuals. Ultimately, these endogenous shifts in the housing supply likely drove up citywide rents, damaging housing affordability for future renters, and counteracting the stated claims of the law.” (Diamond, McQuade & Qian, 2019, p 3).

35 Ekonomifokus, 2018.

36 Swedish Fiscal Policy Council, 2019, p 23: “Since the 1990s, the number of co-op flats have increased by around 50 percent while the number of rental apartments has stayed the same. From 1997 to 2012, the number of rental apartments decreased by 94,000, while the number of co-op flats increased by 234,000.”

37 Swedish Fiscal Policy Council, 2019, p 68.

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indebtedness has significant personal and macroeconomic implications.<sup>38</sup> In its 2018 stability report, the Swedish central bank labelled excess household debt, of which 80 percent is attributable to mortgages, as the “greatest risk to the Swedish economy”.<sup>39</sup>

The rising price of housing hurt young people the most. While overall rates of home ownership have stayed level since the 1980s, home ownership among the young has fallen by half.<sup>40</sup> Among young people who do own their home, an ever-greater share receive financing from relatives.<sup>41</sup>

### **3) Subletting**

The regulated rental market has fed two parallel systems that address the housing needs of market outsiders: the secondary market, and the black market for primary contracts (discussed in the next section).

Primary tenants keen to realise the full economic value of their contracts and prospective renters desperate for housing have created a booming secondary market where rents are significantly higher than those in the primary market. In the country at large, secondary rents for rental flats are 65 percent greater than primary rents. For co-op flats, secondary rents are 138 percent greater than primary rents on the rental market. In greater Stockholm, secondary rents are 104 percent greater than primary rents on the rental market, and 156 percent greater on the co-op flat market.<sup>42</sup>

In other words, primary tenants are able to capture significant pure economic profit by subletting their apartments. Potential profits are greater in Stockholm than in the rest of the country, and greater for co-op flats than rental apartments.

The higher rents claimed in the secondary co-op flat market compared to the secondary rental market is partly due to the 2013 reform which allowed co-op flat owners to cover their cost of capital when subletting. This has allowed for greater price flexibility in the co-op subletting market. Renters reletting their apartments are subject to the utility value system – such that the sub-letter has the right of appeal to the Rent and Tenancy Tribunal

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38 Ministry of Finance, 2015, p 69.

39 Mölne, 2018.

40 SCB, 2018c.

41 Persson, 2017, p 6.

42 National Board of Housing, Building and Planning, 2018b, p 41.

for the retroactive restoration of excessive rents paid.<sup>43</sup> Although the high rents mentioned above suggest that many subletters ignore these rules, the legal framework is still believed to have had a moderating effect on the price level in the secondary rental market.

Theoretically, there is a negative correlation between the rent levels on the primary and secondary markets. As the difference between regulated rents and would-be market rents grow under rent regulation, secondary market rents increase.<sup>44</sup> Low primary rents thus benefit well-educated, socially connected people twice over: they get to pay artificially low primary rents and get to receive artificially high secondary rents when subletting. This comes at the expense of young people, immigrants, and the socially disadvantaged.

This problem is exacerbated by the fact that high demand for primary contracts makes it possible for landlords to impose stricter criteria on potential renters.<sup>45</sup> For example, landlords have long been able to require that tenants pay no more than a third of their incomes in rent.<sup>46</sup> This effectively blocks weaker groups with low incomes and social problems from accessing the primary market. As a result, the disadvantaged are forced to resort to the secondary market and pay the exorbitant rents charged. This weakens their security of tenure and exposes them to the vicissitudes of a market governed by the scruples of landlords.<sup>47</sup>

Thus, the current system comes at the expense of the poor and the vulnerable. In an interview, the Co-Ordinator for Combating Organised Crime at the Stockholm Police Department describes how newly arrived immigrants and guest workers without experience of the Swedish housing market are housed in overcrowded apartments where multiple families live. Some even live in what is known as 'mattress housing'; where dozens of people live as lodgers in a single apartment – facing tough conditions and paying sky-high rents.<sup>48</sup>

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43 National Board of Housing, Building and Planning, 2018b, p 72. In practice, there is no legal right to charge more than the apartment's utility value plus 15 percent for furniture. See also SOU 2015:48.

44 National Board of Housing, Building and Planning, 2018b, p 72.

45 Lind, 2016, p 14, p 110; Property Owners & SABO, 2018, p 3.

46 Kopsch, 2019b.

47 National Board of Housing, Building and Planning, 2011, p 8; Malcom Jallow, 2019.

48 TT, 2019a.

#### 4) *Black markets*

Renters are entitled to trade their contracts for other rental contracts, subject to the approval of the landlord.<sup>49</sup> However, an increasing number of these trades are conducted for appearance's sake – shams, which allow rental contracts to be bought and sold on the black market for tens or even hundreds of thousands of euros. Attractive centrally located apartments are formally traded for cheap housing in the outer suburbs, with actual consideration – so-called key money – being paid illegally under the table. One recent example, which garnered much media attention, was the case of a high-ranking CEO, who has served on the board of multiple state-run enterprises. She was evicted after being found guilty in the Rent and Tenancy Tribunal of having illegally paid in excess of 220,000 euros for a six-bedroom rental apartment in a fashionable Stockholm borough.<sup>50</sup>

The phenomenon, however, is more pervasive than this example suggests. According to one survey, almost a fifth of young tenants in greater Stockholm admit to having illegally paid for a tenancy contract – which is in all likelihood an underestimation.<sup>51</sup> In the Property Owners' Survey of 2006, the authors estimate the black market for tenancy contracts to be 60 million euros in central Stockholm, and 110 million euros in greater Stockholm.<sup>52</sup> The selling of rental contracts has been illegal for long, but in April 2019 a new law was passed banning their purchase as well. "Anyone who paid money for a lease can be punished with imprisonment for up to two years. The penalty scale for selling rental contracts ranges from fine to imprisonment for a maximum of four years."<sup>53</sup> Although the stricter penalties are instituted to deter serious organized crime, the system at large puts a great number of otherwise law-abiding people in a precarious position where their only path to obtain adequate housing is associated with an unforeseeable risk of criminal punishment.<sup>54</sup>

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49 12 chapter 55 § Jordabalken.

50 2.4 million kronor; Rosenlund, 2019.

51 Government Office of Sweden, 2017, p. 67; Kopsch (2019b) notes that the survey conducted by the Swedish Union of Tenants, which only polled 1,000 current tenants, in all likelihood underestimates the extent of the phenomena – given the social stigma and illegality of the activity.

52 660 million kronor and 1.2 billion kronor respectively; Fastighetsägarna, 2006, p. 10.

53 Government Office of Sweden, 2017, p. 67; Faust, 2018; Parliament of Sweden, 2018; The criminalising the purchasing of rental contracts is likely to be counterproductive, as Kopsch (2019b, p. 175) notes, since the threat of punishment will dissuade unsatisfied buyers from reporting the black market seller in the hope of having one's money restored. Karlsson, 2019.

54 TT, 2019b.

The buying and selling of primary contracts has fed a black market operated by criminal gangs.<sup>55</sup> Gangs use this market for money-laundering purposes, channelling gains from other criminal enterprises like the arms and drugs trade.<sup>56</sup> In 2014, Sweden saw a wave of five homicides relating to individuals linked to the illegal trade of rental contracts.<sup>57</sup> The problem is further exacerbated by the fact that the renters themselves are often reluctant to report criminal incidents, since it is feared that this would expose their own illegal renting.<sup>58</sup> As a result, rent regulation breeds lawless spaces in Sweden's major cities.

### **5) Inefficient utilisation of the housing stock**

The first problem discussed above concerns supply-related economic inefficiencies – stemming from the stock of apartments being smaller than it otherwise would have been. However, echoing the observation made by Gleaser & Luttmer (2003), “the standard analysis of price controls assumes that goods are efficiently allocated even where there are shortages. But if shortages mean that goods are randomly allocated across the consumers that want them, the welfare costs from misallocation may be greater than the undersupply costs.”<sup>59</sup> This rings true in Stockholm.<sup>60</sup>

The National Board of Housing, Building and Planning estimates the total welfare loss attributable to the dysfunctional rental market to be one billion euros per year – 400 euros per Swede living in a metropolitan region.<sup>61</sup> 90 percent of that loss results from an inefficient utilisation of the current apartment stock – an allocation-related economic inefficiency.<sup>62</sup> This welfare loss stems from apartments not being distributed according to renters' willingness and ability to pay. A large share of this inefficiency is attributable to low residential mobility and lock-in effects within the existing apartment stock, whereby renters (often older and single inhabitants) are

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55 Government Office of Sweden, 2017, p 89: “There is an illegal trade in leases. Trade is most common in the Stockholm area, but also occurs in other areas of the country, especially in places with a large housing shortage. Illegal trafficking in leases occurs within the framework of organised crime in Stockholm.”; Swedish Police Authority, 2015.

56 Dagerstig, 2018, p 20.

57 Pettersson, 2015.

58 Rogberg, 2015.

59 Gleaser & Luttmer, 2003, p 1027.

60 Especially so given that a random allocation of apartments is sometimes proposed as a welfare-improving reform over the current queueing system which (as discussed below) favours insiders with high social capital.

61 SCB, 2018a; Stockholm, Göteborg, Malmö: combined population, 2.5 million; Söderberg, 2013, p 3.

62 Söderberg, 2013, p 3.

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effectively subsidised by below-market rents to remain in large apartments in attractive locations.<sup>63</sup>

### **6) Recruitment problems**

A poorly functioning housing market has negative downstream effects on the economy at large. An inability to obtain adequate housing results in an inefficient use of labour and other economic resources, which leads to a lower overall economic output. These effects are difficult to isolate and quantify. However, it is telling that, in a survey of companies operating in Sweden conducted by the Confederation of Swedish Enterprises, a fifth of respondents claimed that housing shortages had made recruitment more difficult during the previous year.<sup>64</sup>

Many growing companies in knowledge-intensive industries report barriers to housing as a major obstacle to the recruitment of highly qualified foreign workers.<sup>65</sup> Spotify, a music streaming service, has full-time staff in its Stockholm office dedicated to arranging housing for its 800 employees.<sup>66</sup> The firm's co-founder Martin Lorentzon claimed, in a round-table discussion with Finance Minister Magdalena Andersson, that out of the 58 countries the firm operates in, Stockholm has the greatest obstacles to obtaining housing.<sup>67</sup>

### **7) Social segregation**

Rent controls create a sharp divide between two groups of households: insiders, who have primary leases on rental apartments, and outsiders, who lack such contracts even though they would be willing to pay rents higher than those actually paid by the insiders.<sup>68</sup> Those who do manage to enter the primary market can reap the rewards of the price ceilings, while those who do not get to experience their major unintended side effects.<sup>69</sup>

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63 Leijonhufvud, 2014; Abramsson, Elmqvist & Magnusson Turner, 2014, p 49.

64 Karlsson, 2016, p 9.

65 Bornefalk, 2017, p 82.

66 Orre, 2015.

67 This is discussed in the company's 2016 open letter concerning Stockholm's housing market, see VA (2016).

68 Enstrom Öst, Söderberg & Wilhelmsson, 2014, p 370.

69 Enstrom Öst, Söderberg & Wilhelmsson, 2014, p 370.

This lot is not equally distributed across socioeconomic groups. Brogren & Fridell (2007) find that “residents in rent-controlled apartments in attractive locations ... are [typically] born in Sweden by Swedish parents and that they are likely to have a higher income than residents in rent-controlled apartments in less attractive locations.”<sup>70</sup> This is not surprising, given the long queueing times.

Several prominent politicians have been embroiled in scandals after it has been revealed that they relied on political connections to obtain rental apartments due to be returned to the housing agency – effectively cutting the queue.<sup>71</sup> As a telling example, former Foreign Minister Margot Wallström was accused of taking bribes when she used her union contacts to obtain a high-end rental apartment in central Stockholm.<sup>72</sup> “[R]ent regulation in Stockholm does not succeed in reducing segregation”, Brogren & Fridell (2007) conclude, “on the contrary, the regulated rental market is more segregated than the free housing market.”<sup>73</sup>

As observed by Faust & Karreskog (2017), it is often those with greater social capital who are able to obtain primary rental contracts. And if one obtains such a contract, much is done to retain it within one’s own social circle. Consequently, popular addresses have been inhabited by the same families for decades.<sup>74</sup> The result is that the “rental market is segregated in particular with regard to national origin; especially disadvantaged are first- and second-generation immigrants.”<sup>75</sup> This is in contrast to the co-op flat market, where national origin seems to have no bearing on how attractively an individual lives, when controlling for income.<sup>76</sup> Hence, rent controls cause geographic segregation by undermining socially disadvantaged people’s ability to live in Sweden’s inner cities.<sup>77</sup>

The Housing Crisis Committee (2014), commissioned by the Swedish Property Federation and the Chambers of Commerce (for Southern Sweden, Western Sweden, and Stockholm) to provide concrete reform proposals to improve the functioning of the Swedish housing market,

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70 Brogren & Fridell, 2007, p 1.

71 Cardona Cervantes, 2016.

72 Carlson, 2016; Rosen & Carlsson, 2016.

73 Brogren & Fridell, 2007, pp 22-23.

74 Karreskog & Faust, 2017, p 9.

75 Karreskog & Faust, 2017, p 9.

76 Brogren & Fridell, 2006, pp 22-23.

77 Enstrom Öst, Söderberg & Wilhelmsson, 2014. An extensive literature supports the idea that reduced segregation results in positive socioeconomic effects, e.g. Ludwig et al (2001).

suggested that:

*The conclusion is that rent control has not achieved its goals. It has been unable to stop segregation with respect to income – while possibly aggravating segregation with respect to origin. First- and second-generation immigrants are put at a disadvantage. Rent control thus does not achieve the goal often cited as the main argument for its existence.<sup>78</sup>*

### **8) Inefficient instrument for redistribution**

It is often argued that rent controls reduce the role of income as a determinant of housing. However, if the central aim of this ambition is to improve the lot of low-income earners, rent regulation is an inefficient tool. Enström Öst et al. (2014) argue that if one wishes to counteract income segregation and “subsidise housing consumption for families with children, immigrants, and those who are mobile in the housing market, the utility rent system is a blunt instrument, and possibly a directly counterproductive tool.”<sup>79</sup> Instead, to “increase opportunities in the housing market for certain economically disadvantaged households”, other, more targeted, measures should be considered.<sup>80</sup>

Two rent-control-induced effects interact to ensure economic segregation: first, well-off individuals have greater formal and informal opportunities to access highly subsidised apartments, and second, excess demand allows landlords to be selective among prospective tenants – deselecting socioeconomically vulnerable people.

To illustrate the impact of these effects on the ability of rent regulation to function as a redistributive tool, one need only consider that the

78 Eklund, 2014, p 23.

79 Enstrom Öst, Söderberg & Wilhelmsson, 2014, p 371. The counter-productivity of rent controls is echoed in Diamond, McQuade & Qian (2019). They write: “Taking all of these points together, it appears rent control has actually contributed to the gentrification of San Francisco, the exact opposite of the policy’s intended goal. Indeed, by simultaneously bringing in higher income residents and preventing displacement of minorities, rent control has contributed to widening income inequality of the city.” (Diamond, McQuade & Qian, 2019, p 5).

80 Enstrom Öst, Söderberg & Wilhelmsson, 2014, p 371; The same conclusions are reached in Diamond, McQuade & Qian (2019). They write: “If society desires to provide social insurance against rent increases, it may be less distortionary to offer this subsidy in the form of government subsidies or tax credits. This would remove landlords’ incentives to decrease the housing supply and could provide households with the insurance they desire.” (Diamond, McQuade & Qian, 2019, p 5).

households occupying the 512 rental apartments in Stockholm that are larger than 180 square meters had an average income of 251,000 euros. This is equivalent to the top income percentile in Sweden.<sup>81</sup> The greatest indirect subsidies go to these attractively located large apartments.<sup>82</sup> The queues for heavily rebated dwellings are the longest, and the people who are willing and able to queue for, or through other informal means get access to, the aforementioned subsidies tend to have relatively high incomes.<sup>83</sup> This, in combination with previously discussed social segregation, makes it unsurprising that those who receive the greatest indirect subsidies tend to be high income earners.

Lind & Hellström (2006) provide an account of rent regulation's impact on economic segregation in Malmö and Stockholm since the 1990s, when the two cities took different approaches to housing policy. According to the authors, this "natural experiment" demonstrates that despite Malmö's slow move toward market-oriented rents, segregation increased in almost the same way in both cities. The authors conclude that:

Increased income differences in a society will be reflected on the housing market both in a system with more regulated rents and in a system with more market-oriented rents. Even if there is rent regulation it will be possible for higher income groups to get hold of attractive apartments: They more often have something to trade with, they can use trade-ins from the ownership market, they can buy apartments on the black market, and they may also have been tactical and started to queue for an apartment many years before they need one.<sup>84</sup>

In other words, when measuring real world outcomes, there is little evidence to suggest that Sweden's rent regulation has in any way reduced economic segregation. Indeed, taking stock of the system's unintended side-effects, it has likely done the opposite.

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81 2.7 million kronor; Sandberg & Aschberg, 2017. Assuming those households contain two wage earners, this makes for an average wage of 10,450 euros per person per month. For reference, in Sweden the national 99th income percentile earns on average 6,309 euros per month, and the 100th income percentile earns on average 10,706 euros per month (Lapidus & Bengtsson, 2014).

82 Enstrom Öst, Söderberg & Wilhelmsson, 2014, p 371.

83 Kopsch, 2019b, pp 146-148.

84 Lind & Hellström, 2006, p 188.

### 9) *Inefficient renovation decisions*

Rent controls usually hamper the upkeep of the housing stock – after all, what incentives are there for expensive renovations if landlords cannot recoup their investments by raising rents? A famous quote says that “rent control appears to be the most efficient technique presently known to destroy a city – except for bombing”.<sup>85</sup> Under the Swedish system, however, landlords are only permitted to raise rents if it is associated with a renovation. This, contrary to expectations, produces an inefficiently *high* standard of the housing stock.<sup>86</sup>

The rules concerning rent hikes are tied to two interrelated concepts: standard-raising renovations and regular maintenance work. The former grants landlords the right to raise rents, while the latter does not. As an illustrative example: if a landlord undertakes a bathroom renovation and replaces the plastic carpet and the tiles in a half-tiled bathroom, they are undertaking maintenance work and are not permitted to raise rents. However, if the landlord replaces the half-tiled bathroom with a fully tiled bathroom, then it is classified as a standard-raising investment which can be accounted for in the utility-value determination – thus granting him the right to raise rents.<sup>87</sup>

The consequences are twofold. First, it incentivises landlords to delay regular consumer surplus-generating maintenance work for as long as possible – causing decay of the housing stock. This may be seen in the 1960’s public housing programme, “the Million Programme”, where a fifth of all flats currently have urgent renovation needs, since they have “exceed their technical lifespan of 50 years without any major renovations”.<sup>88</sup> Second, it incentivises landlords to undertake expensive economically inefficient renovations for the express purpose of raising rents.

An artificially high housing standard may seem attractive at first glance, but it comes with unintended side-effects. Lind (2015) argues that the high housing standard generates greater income segregation between different

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85 Lindbeck, 1970.

86 The economic incentives in the Swedish rental market are specifically designed to prevent housing decay. However, not surprising given the impossibility of correct centralised pricing, the Rent and Tenancy Tribunal has overshot the mark. This mispricing is not restricted to location and tiling: Bredberg & Kockum (2017) write about how landlords and the Union of Tenants have negotiated that a 29-kronor (3-euro) spice rack legitimizes a 10-kronor (1-euro) monthly rent hike in perpetuity.

87 Example taken from Lind (2015).

88 Ferm, 2019.

geographic areas than what would be the case under free market conditions. This is because a free market could cater to individuals with low incomes who value living in attractive locations but not high housing standards. Such apartments are not available under Swedish rent regulation. Kopsch (2019b) argues that this is due to mispricing by the Rent and Tenancy Tribunal. Simply put, location is under-priced, and standard is overpriced. As a result, landlords are forced to game the system: only by renovating excessively can they tap into the apartment's rent potential.

Low-income city-dwellers, typically students or young professionals, are unable or unwilling to bear the cost of large renovation projects. As a result, they will be secluded to less attractive housing markets along with low-income households who do not value living in central locations. Apartments in the latter housing markets are therefore reserved for high-income earners who can shoulder the aforementioned costs.

Lind's (2015) reasoning on economic segregation is borne out by the empirical evidence. Tenants in rental apartments subject to renovations are twice as likely to relocate compared to tenants not subject to renovations.<sup>89</sup> In a report, the National Board of Housing, Building and Planning finds a clear negative correlation between the tendency to relocate upon renovation and relative income. The same pattern holds true for families with children – who are far more likely to move out when renovations begin.<sup>90</sup>

The redistributive effects of Sweden's rapid pace of renovation are therefore quite clear. It has improved wealthier people's ability to access newly renovated rental apartments in attractive locations at the expense of lower-income people's ability to access affordable housing without long commutes.

The Swedish system illustrates a general problem with rent regulation, since renovations need to be incorporated in the system in some way. Unless rent-setters can price renovations correctly, which is unlikely, renovation decisions will be distorted – resulting in either under- or over-renovation.

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89 National Board of Housing, Building and Planning, 2014, p 7.

90 National Board of Housing, Building and Planning, 2014, p 7.

## Conclusion

This report describes some of the negative effects of Sweden's rent regulation. The system has hampered economic development and social mobility. It has caused housing shortages in cities by reducing the stock of apartments and impeding the efficient utilisation of that stock. This has diminished Swedish companies' ability to recruit and limited Sweden's overall economic output. Although the institutional characteristics are particular to Sweden, the problems are general and will to some degree affect all countries or regions that introduce rent controls.

In Sweden, these economic costs have come without significant distributional or social benefit. In fact, rent controls cause greater social segregation, both through stricter criteria on potential renters and through the retention of apartments among families with high social capital.

The flow of subsidised apartments to well-connected individuals neuters the system's egalitarian ambitions. Large apartments in attractive areas receive the greatest indirect subsidy. Those apartments tend to be occupied by older, wealthy, well-educated, native-born people without children living in the household.

As a result, rent controls have no mitigating effects on economic segregation. It does however force unfortunate outsiders into the expensive secondary market, which deprives them of their full security of tenure, or to the black market, making them dependent on criminal gangs.

These outcomes should serve as a cautionary tale for those wishing to regulate rents. Rent controls not only impose immense economic costs but also fail to achieve their primary policy aims and foster political dysfunction along the way:

- When Parisian legislators argue that rent controls will allow the city to get a “grip on the spiralling cost of living” they fail to appreciate that in the long-run rent regulation causes a bifurcated market, with low primary rents and high secondary rents such that an outsider moving in can expect to pay more than he otherwise would.<sup>91</sup>
- When Berlin legislators suggest that rent controls will “calm the overheated rental market”, they fail to recognise that disabling the price mechanism in the rental market will in the long-run cause an overflow of excess demand into the market for owner-occupied housing – sparking excessive indebtedness and further socioeconomic segregation.<sup>92</sup>
- When Californian lawmakers suggest that rent controls are necessary since they cannot to build their way out of the housing crisis, they fail to recognise that rent controls further dissuade housing construction and causes inefficient use of the existing stock of apartments. This essentially means subsidising old wealthy tenants to remain in large apartments.<sup>93</sup>
- The same legislators suggest that rent controls will stop the displacement of socially and economically vulnerable people. This runs contrary to the Swedish experience which suggests that, in the long run, rental contracts will be pooled in the hands of socially connected people via an informal exchange, rather than going to the vulnerable people the policy is intended to help. Thus, socially disadvantaged groups are the ones most likely to be hurt by rent regulation.

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91 See Herold (2019) for a comparative analysis of European rental markets.

92 Berlin expects a wave of conversions come the strict rent-control law (Guthmann, 2019).

93 See Kopsch (2019b) for further discussion on rent controls and housing construction. He argues that it is technically possible to build out one’s way out of the housing crisis. However, attempts made in Sweden during the 1990’s failed. Instead, public resources were spent on constructing housing which was not desired. In addition, Kopsch (2019b) argues that subsidising construction to the point of eliminating queues would be unfeasibly expensive.

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