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International Journal of Industrial
Organizationwww.elsevier.com/locate/ijioA search model of rental markets: Who should pay
the commission?☆Andras Niedermayer^{a,*}, Chengsi Wang^b^a *Economics Department, University of Mannheim, L7, 3–5, Mannheim D-68131, Germany*^b *Department of Economics, Monash University, Building 11, Room E977 Wellington Road, Clayton Vic 3800, Australia*

ARTICLE INFO

Article history:

Available online xxx

JEL Classification:

D82

D83

R31

Keywords:

Search

Dynamic random matching

Brokerage fees

Appointment principle

ABSTRACT

We develop a dynamic search equilibrium model of rental markets with brokerage fees. An endogenous mass of landlords and tenants is active in the search market. While the mass of entering tenants is exogenous, the mass of entering landlords is endogenously determined by the rate at which apartments become vacant. Brokerage fees paid by tenants are used as a device to screen short term and long term tenants. We analyze a policy that requires fees to be paid by landlords. Such a policy decreases efficiency by preventing efficient screening, but also increases turnover and hence efficiency in the search market. We further provide empirically testable implications of our theory.

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1. Introduction

Rental markets are important, since rents comprise a significant fraction of consumers' expenditures (rent expenses account for roughly one third of total expenses in the U.S.

☆ We want to thank Heski Bar-Isaac, Martin Peitz, Jidong Zhou (the editor), and two anonymous referees for very useful comments and Sihong Zhang for excellent research assistance. We are particularly grateful to Andreas Engert for discussions and comments about the German tenancy law.

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<http://dx.doi.org/10.1016/j.ijindorg.2017.06.002>

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and roughly one quarter of expenses in Germany). Recently, the question who should pay real estate brokers' fees in rental market has received considerable attention by the public and by policy makers. In Germany, in June 29, 2015, after considerable public controversy, a law came into effect which bans fees being charged to tenants and requires landlords to pay the fees – the “Appointment Principal” (“Bestellerprinzip”).¹ In 2017 the UK government proposed a similar policy for the UK rental market.² While no such laws have been made in the U.S., there has been academic interest in who pays the fee in rental markets, with the landlords paying the fee in some submarkets and tenants paying the fee in others.³

We develop a search equilibrium model to analyze the effect of which party pays the brokerage fees. In an infinite horizon model, there is a fixed mass of landlords who own apartments. Landlords whose tenants move out of their apartments enter the search market. In every period there is an inflow of potential tenants who search for an apartment. A crucial feature of the model is that tenants are heterogeneous with respect to whether they are short term tenants who move out after a short period or long term tenants. Landlords are also heterogeneous with respect to how costly it is to rent to a short term tenant. The mass of landlords and the mass of tenants actively participating in the search market in a given period is endogenous and determined by how many apartments become vacant and by how many tenants did not manage to find an apartment in the previous periods.

The effect of tenants paying the fee is that it serves to screen short term tenants from long term tenants, because a one-time fee has a greater effect on the per period expenses of a short term tenant than on the per period expenses of a long term tenant. If the landlord – rather than the tenant – pays the fee, screening is no longer possible with rents that are constant over time.⁴

This highlights a welfare reducing effect of banning tenant fees: screening is not feasible, so that landlords with high costs may choose to leave their apartment vacant as long as their costs stay high rather than rent their apartments out, which would lead to the risk of being matched with a short term tenant. However, there is also a more subtle welfare increasing effect of the landlords paying the fee, which only appears in a dynamic search environment. Landlords face uncertain moving-out cost if their current tenants stay for longer periods. Thus, landlords bear a high risk to rent to long term tenants, which is very costly when the moving-out cost is high. However, it is

¹ In theory, the law prescribes that the party who hires the real estate broker should pay the fees. In practice, the law effectively bans fees being charged to tenants and requires landlords to pay the fees. While in theory, a broker could be hired by a prospective tenant, so that the tenant would have to pay the fee, this is not feasible in practice. The reason is that if a tenant were to hire a broker, then the tenant would have to have an exclusive agreement for an apartment, i.e., the broker would not be allowed to show that apartment to other tenants. This makes it unattractive for brokers to be hired by tenants. For details, see [Michaelis and von Wangenheim \(2016\)](#).

² See <https://www.gov.uk/government/news/government-action-to-ban-letting-agent-fees> for more details.

³ See [Bar-Isaac and Gavazza \(2015\)](#).

⁴ Rental contracts with rents that are not constant over time could be used to emulate tenant fees. However, there are a variety of restrictions that make such contract impractical. We will discuss these restrictions later on.

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