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Tenancy rent control and credible commitment in maintenance[☆]

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ABSTRACT

Under tenancy rent control, rents are regulated within a tenancy but not between tenancies. This paper investigates the effects of tenancy rent control on housing quality and maintenance. Since the discounted revenue received over a fixed-duration tenancy depends only on the starting rent, intuitively the landlord has an incentive to spruce up the unit between tenancies in order to “show” it well, but little incentive to maintain the unit well during the tenancy. The paper formalizes this intuition and presents numerical examples illustrating the efficiency loss from this effect.

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1. Introduction

Tenancy rent control is a form of rent control in which rents are regulated within a tenancy but may be raised without restriction between tenancies; more specifically, the starting rent for a tenancy is unregulated but the path of nominal rents within a tenancy, conditional on the starting rent, is regulated, typically causing rents to rise less

rapidly over the tenancy than they would in the absence of controls.¹ Many, perhaps most, jurisdictions around the world that previously had traditional first- and second-generation rent control programs (Arnott, 1995) have moved in the direction of tenancy rent control as a method of partial decontrol.²

In jurisdictions that have stricter forms of rent control, tenancy rent control may be an attractive method of partial decontrol. Because the starting rent adjusts to clear the market, tenancy rent control does not generate the excess demand phenomena (such as key money, waiting lists, and discrimination) of stricter rent control programs, and should have a less adverse effect on the matching of households to housing units.³ Tenancy rent control continues to provide sitting tenants with improved security of tenure, for one thing rent, regulation

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This paper is dedicated to the memory of John Quigley. As much as anyone, John forged the character of modern urban economics, with its healthy interplay between theoretical and empirical analyses, and its concern for practical public policy issues, particularly those related to the disadvantaged. John's energy did much to vitalize the field, and his generosity to junior colleagues (including Arnott) and graduate students was a legend. This paper is a doubly appropriate tribute, because John's principal research interest was housing economics, and his critical comments on an earlier version of the paper provided the spur for the “serious” calibration of Section 5's numerical example.

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¹ This defines the “ideal type”, which is what will be modeled in this paper. Many jurisdictions have forms of rent control that are intermediate between tenancy rent control, according to the above definition, and more traditional forms of rent control. In some, rent increases are regulated both within and between tenancies, but less severely between tenancies than within tenancies. In others, rent increases are unregulated between tenancies but are subject to a variety of regulatory provisions within a tenancy, such as a guideline rent increase (which allows rents to rise by a certain percentage per year) with a cost-pass-through provision (which allows the landlord to apply for a rent increase above the guideline rent increase if justified by cost increases).

² Basu and Emerson (2000, 2003) and Arnott (2003) list some of these jurisdictions. Borsch-Supan (1996) models the current German system and Iwata (2002) the current Japanese system, both of which are termed “tenant protection” systems.

³ There is a large literature on the adverse effects of rent control. Three particularly good papers that avoid polemical rent-control bashing are Frankena (1975), Glaeser and Luttmer (2003), and Olsen (1988).

within tenancies precludes economic eviction; for another, because tenancy rent control, like other forms of rent control, provides landlords with an incentive to evict tenants, it is invariably accompanied by conversion (rehabilitation, demolition and reconstruction, and conversion to condominium) restrictions.⁴ As well, tenancy rent control may be a politically attractive method of partial decontrol since it continues to provide rent protection to sitting tenants, who are typically the strongest opponents of decontrol. These benefits must be weighed against the costs. The most obvious costs are the tenant lock-in created by tenancy rent control and the unfairness of the preferential treatment of sitting tenants. There are also less obvious costs. The workability of tenancy rent control makes it more difficult to move to complete decontrol, should this be deemed desirable. Also, because a rent control administration is kept in place, it is relatively easy to return to harder controls should the political winds change. Landlords, fearing this, may curtail investment.⁵

This paper focuses on another less obvious cost of tenancy rent control — its adverse effect on maintenance. Pollakowski (1999) provides an empirical analysis of the effects of New York City's rent control system on housing maintenance there. Arnott and Johnston (1981) provide an informal, diagrammatic discussion of the effects of several rent control programs (though not tenancy rent control) on housing quality and maintenance. This paper will adapt the model of Arnott et al. (1983) to examine how the application of tenancy rent control to a single atomistic landlord–builder affects his profit-maximizing behavior.⁶

Assume, as we will throughout most of the paper in order to abstract from the tenant lock-in effect, that tenancy duration is exogenous. There are two conflicting intuitions concerning the effects of tenancy rent control on the atomistic landlord's behavior. A lay person with good economic intuition would probably argue that tenancy rent control gives the landlord an incentive to spruce up his units between tenancies so that they “show” well and hence can be let at a higher starting rent, but little incentive to maintain the units well during tenancies, since, after the starting rent has been agreed upon, maintaining well has no effect on the rent stream during the tenancy. An economist might however reasonably object that, with tenancy duration exogenous, there is nothing to prevent the landlord from following the program that is profit-maximizing in the absence of tenancy rent control — which we shall term the *efficient program*. If the landlord follows this program, the tenant should be willing to pay as much over her tenancy as she would have for an uncontrolled unit. This line of reasoning suggests that, were it not for the tenancy lock-in, the landlord's profit-maximizing program would be unaffected by the application of tenancy rent control.

The resolution of the two conflicting intuitions lies in the ability of the landlord to credibly commit to the efficient program. If he is able to credibly commit to a maintenance program, he will credibly commit to the efficient program and the tenant will agree to pay the same in rent in discounted terms over the duration of the tenancy as in the absence of rent control. The landlord will therefore be making the same revenue and incurring the same costs as in the absence of rent control, and can surely do no better than this. Thus, if the landlord can credibly commit to the efficient program, tenancy rent control alters the timing of rent payments over a tenancy but generates no inefficiency.

If, however, the landlord is unable to credibly commit to pursuing the efficient program, once the lease is signed he has an incentive to pursue a

different maintenance program, which we term the *opportunistic program*. Since the signing of the lease fixes the discounted rent that the landlord will receive over the current tenancy, the only incentive he has to maintain is to improve the quality of the unit at the end of the lease, as this will increase the discounted rent he receives on subsequent tenancies. Compared to the efficient program, the opportunistic program entails both a reduction in average maintenance and a postponement of maintenance within a tenancy. Before the lease is signed, a prospective tenant should in this situation realize that under tenancy rent control the landlord will pursue the opportunistic rather than the efficient maintenance program and hence not be willing to pay as high a starting rent as she would if he were to pursue the efficient program.

The crux of the matter is therefore the landlord's ability, under tenancy rent control, to commit to a particular maintenance program. Three commitment mechanisms might be partially effective. The first is contracting on maintenance. One problem with this commitment mechanism is that, since maintenance is such an amorphous concept, maintenance clauses in the lease would be highly incomplete; for example, if the contract were to require the landlord to replace appliances every ten years, he might replace with appliances that are used and reconditioned or of minimal quality. Another problem is that it would be costly for a tenant to document sufficiently well to meet the standard of evidence of the courts and real estate tribunals that her landlord had not met the maintenance terms of the contract. This is the familiar problem of costly state verification. The second commitment mechanism, reputation, is likely to be ineffective since the typical prospective tenant knows little or nothing about different landlords' maintenance performance when she is searching for a unit. The third mechanism, maintenance regulation, suffers from problems similar to those for contracting on maintenance. In our judgment, such commitment devices are largely ineffective, and in our analysis we shall assume them to be completely ineffective. The efficiency costs that we identify are reduced to the extent that these commitment mechanisms are indeed effective.

Section 2 presents a preliminary, stripped-down model that highlights the maintenance distortion caused by tenancy rent control when landlords are unable to credibly commit to the optimal program, which we term the commitment-in-maintenance (contractual) failure. Section 3 presents the central model in the absence of rent control, which is a particular case of Arnott et al. (1983). Section 4 applies the central model to the analysis of tenancy rent control. Section 5 presents a calibrated example focusing on the magnitude of the efficiency loss caused by tenancy rent control. Section 6 briefly discusses how the paper's modeling of the housing market might be extended to provide a richer treatment of tenancy rent control, and briefly notes some additional effects of tenancy rent control this richer treatment leads to. Section 7 concludes.

2. A stripped-down version of the model

The central model is quite complex, employing optimal control theory. To elucidate the economics, we start with a stripped-down model. The model considers the profit-maximizing maintenance choices, in a stationary environment, of a landlord who buys a unit of housing (i.e., a unit area of floor space) and then rents it out to the same tenant⁷ for two equal-length periods, at the end of which the tenant moves out and the landlord sells the unit. A unit's quality in a period, q_t , is a function of its quality over the previous period, q_{t-1} , and maintenance expenditure undertaken at the end of the previous period, m_{t-1} :

$$q_t = g(q_{t-1}, m_{t-1}), \quad (1)$$

which we term the quality change function. In the absence of rent control, in each of the two periods the tenant pays the uncontrolled,

⁷ The analysis is conducted per unit of housing (i.e., per unit area of floor space).

⁴ Miron and Cullingworth (1983) examine the effects of rent control on security of tenure.

⁵ These less obvious costs are evident in the Ontario experience with rent control (e.g., Smith, 2003).

⁶ Since the analysis is “very” partial equilibrium, it will ignore the effects of tenancy rent control on the level of rents and on other markets such as the labor market. While the paper focuses on tenancy rent control, the techniques employed can be applied to examine the effects of other forms of rent control on the landlord's optimal program (indeed, Arnott and Johnston (1981) does so, albeit informally).

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