The Effects of Contractual Regulation on the Rental Housing Market

Pol Borrellas

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Universitat Pompeu Fabra
Supervisor: Joan Tubau

Abstract

The purpose of this paper is to determine whether restricting contractual freedom in the rental housing market is an effective mechanism to maximize social welfare. For this, the author analyzes the most significant measures enacted by the Spanish government in March 2019 and discusses their potential long-term effects. The examinations are based on principles of economic theory and empirical evidence from literature. Contractual regulation is shown to directly cause undersupply of rental housing and upward pressure to prices. Additionally, low-income tenants, who are more likely to have a precarious work and spend a larger proportion of their disposable income on housing, appear to be the most severely affected because lessors cannot effectively hedge against the higher risk this type of lessee entails. Indirect effects, such as inefficient allocation of resources, suboptimal labor mobility and discrimination of tenants are also discussed. It is found that contractual freedom, legal certainty, ease of construction and judicial efficiency are the key drivers for an efficient rental housing market, which maximizes social welfare.

Keywords: Rental housing market, contractual regulation, rent control
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1. Introduction

Recent hikes in housing rents in Spain, specially in the largest cities, have motivated an intense public debate on the ways to soften and invert them. Social agents and some political parties argue that the increase in rental housing prices expels low-income local families from their neighborhood and hinders their access to housing. Accordingly, they propose tougher contractual regulation to solve the phenomenon.

In March 2019, the Spanish government enacted a royal decree-law containing several modifications to the urban leases law. Its aim is to ease the access of low-income citizens to rental housing by further protecting the tenants. The most meaningful changes introduced to residential lease contracts establish: (1) a minimum tenure; (2) a limitation on price updating; (3) a fixed security deposit and (4) restrictions on eviction processes. Additionally, this legal rule orders the creation of a rental price benchmark.

Likewise, the possibility to set a maximum rental price founded on the price benchmark is also being debated.

The potential undesired consequences of the above-mentioned measures generate great concern given the importance of the matter. As famously stated by Kerr (1975), this could be another senseless regulation encouraged by policymakers’ excessive emphasis on short-term electoral gains. Indeed, it may actually hinder housing access to the low-income families the Spanish government pretends to aid.

The purpose of this paper is to determine whether restricting contractual freedom in the rental housing market is an effective mechanism to maximize social welfare. For this, I analyze the most significant measures enacted by the Spanish government and discuss their potential long-term effects. The examinations are based on principles of economic theory and empirical evidence from literature.

Although there is a rich body of literature on this topic (Arnott, 1995; Bulow & Klemperer, 2012; Downs, 1988; Glaeser & Luttmer, 1997), this study contributes to it by providing a comprehensive and updated analysis of both the direct and indirect effects of contractual regulation on rental housing market.

The paper is organized as follows. Section 2 discusses the characteristics and specificities of the rental housing market. Section 3 addresses six different types of contractual regulation separately. First, the measure is discussed at a general level. Then, the Spanish specific case is considered. Section 4 concludes and summarizes the main findings.
2. The nature of the rental housing market

Markets exist because they allow individuals to specialize. Specialization triggers productivity gains and social welfare is enhanced. In other words, markets are welfare enhancing mechanisms. Thus, citizens, policymakers and judges should be interested in facilitating and enhancing the well-functioning of markets.

Unfortunately, the perfect functioning of markets is difficult to be obtained naturally because of our ecological rationality, which is not adapted to properly deal with modern exchanges (Arruñada, 2008). Accordingly, individuals may misunderstand the benefits of trade and be reluctant to deal with anonymous parties. The malfunctioning is also aggravated by diverse phenomena, such as the presence of monopolistic structures, imperfect information and product differentiation. These difficulties generate distortions and transaction costs that may hinder exchanges and reduce social welfare.

The rental housing market is not an exception. First, dwellings offered for rent and tenants are not homogenous. That is, there are significant differences in the quality of apartments and lessees and in the specific preferences of the latter. This heterogeneity creates differentiated rental housing markets based on the particular features of the dwellings and the tenants. These distinct markets may suffer shocks in different ways. For example, a given regulation may more heavily reduce the supply of low quality houses. This would mostly affect low-income lessees because they are more likely to be interested in this specific kind of dwelling.

Second, it is difficult for landlords to differentiate between good and bad tenants. Good tenants comply with contractual terms while bad ones do not. The combination of imperfect information and heterogeneity of lessees creates an adverse selection problem to lessors, for whom it is complicated to select the good tenants. The consequence is that putting a dwelling up for rent becomes more risky. As a result, landlords may require a higher return and demand the inclusion of mechanisms to screen lessees.

Third, there are neighborhood externalities (Arnott, 1995). That is, the property’s location can be a crucial pricing factor and may allocate monopolistic power to some landlords.

Fourth, rental housing supply is particularly inelastic. This circumstance makes market adjustments slow, specially if usage conversion from owner-occupied to leasing is not sufficient to compensate supply shortages and construction is required.

As a result, rental housing market is not perfect and total welfare in a laissez-faire framework may be suboptimal. Market intervention is usually proposed to solve these conundrums and maximize social welfare. Nevertheless, in this case, contractual regulation may actually reduce it. Section 3 discusses the effects on welfare of reducing the contractual freedom of the parties in the rental housing market.
3. Analysis of contractual regulations

This section examines the effects of six different types of contractual regulation separately. First, the measure is discussed at a general level. Then, the Spanish specific case is considered.

3.1. Minimum tenure

The duration of a lease contract is one of its most salient terms. A wide variety of variables, such as the type of job, age, income, familiar circumstances and future plans of the parties, shape the preferences of both the landlord and the tenant when negotiating the length of the agreement. For instance, a low-income tenant with children attending the nearby school may be willing to sign a long-term contract. Differently, the landlord may be willing to accept only a short duration given the higher default risk of this lessee. In a different manner, a high income tenant with credit trustworthiness may have higher bargaining power and manage to obtain a longer tenure from the landlord.

In general, a higher tenure is associated with a higher risk for the landlord. Given the incomplete nature of contracts, a longer duration implies having to deal with increasing uncertainty about future shocks. This uncertainty includes wide market price fluctuations (e.g. due to increasing popularity of the neighborhood); unexpected changes in the desired use of the dwelling (e.g. because of a sudden need for liquidity) and considerable alterations of the repayment ability of the tenant (e.g. due to his dismissal), among others. Relative to the latter, the common difficulties to rapidly evict failing to comply lessees might importantly affect landlords’ willingness to engage in long tenure contracts. Consequently, there exists a trade-off between tenure and the other variables of the bargaining mix, such as guarantees and price.

Considering the infinite combinations of preferences and bargaining power of the parties, a wide variety of tenures among rental housing contracts are expected. This exact diversity evinces the inefficiency of a mandatory minimum tenure. Establishing a mandatory minimum duration of contracts obliges the parties to use inefficient terms because they cannot effectively match their specificities (Arruñada, 2001). This measure only benefits those tenants who, because of their risk profile, would otherwise only be offered short-term contracts and may have to move frequently. In other words, it may increase their security of tenure. Nevertheless, this may come at the expense of toughening the other clauses of the agreement.

More precisely, not being able to optimally align parties’ specific needs regarding tenure increases risk for the landlord. To hedge against this, lessors may require tougher guarantees and/or a higher price. Therefore, contractual costs rise. Additionally, landlords are incentivized to prefer potential shorter-term tenants, such as students and single people, over longer-term ones, such as families and elderly. The most extreme consequence would be the total rejection to rent the dwelling, which would remain empty or converted to owner-occupied, diminishing supply of rental housing.
These effects are likely to differently affect the parties depending on the characteristics of each landlord and tenant. In particular, the most harmed profiles are low-income lessees, who may be offered a higher price to compensate for their greater risk or even deprived from renting an apartment. This situation can be aggravated by above-average risk aversive lessors. Low-income tenants represent a higher risk for landlords because they are more likely to be temporary employees and keep shifting jobs (Van Lancker, 2012). This circumstance is the main explanation for their low wage and causes income instability. Furthermore, low-income lessees, especially those of the bottom quintile, tend to spend a much larger share of their disposable income on rent (OECD, 2019) and be more protected against evictions. These facts imply that this type of tenant entails a higher risk of default for which landlords have to be compensated with shorter tenures or more guarantees.

In regard to the Spanish case, the newly enacted royal decree-law specifies a minimum tenure of 5 years when the landlord is a physical person and of 7 years when it is a legal person. Besides, the death of the main tenant before the minimum tenure expires entitles the descendants to maintain the contract with the same terms in the case that they are underage, disabled, over 65 years old or considered by a court as vulnerable. This rule would be enforced even when contrarily agreed by the parties. Moreover, in the absence of communication between the parties at the expiration date, the tacit extension of the contract is of 3 years.

As a result, the Spanish law is severely detrimental not only for low-income individuals, who may need to heavily compensate the landlord for the additional risk they represent, but also the elderly, who are not able to negotiate a no-subrogation clause in order to obtain a more favorable aggregate contract, and those in charge of vulnerable people.

Notwithstanding, the rule presents an exception. When landlords are physical persons and clearly state in the contract their willingness to possibly recover the dwelling before the termination of the minimum tenure, they are entitled to do so only if the residence is going to be used as a first home by themselves, their first degree of kinship relatives or their spouses in case of separation or divorce. This exception may, in specific cases, partially offset the negative effects of setting a mandatory minimum tenure.

3.2. Limitation on price updating

Rental housing prices are affected by several factors, such as changes in the economic activity of the municipality; the variety and quality of the amenities around the dwelling (Banzhaf & Mangum, 2019); the infrastructures and public means of transport available and the attractiveness of owner-occupied housing, among others. These diverse phenomena can be summarized into changes in demand and supply. Taking into account the unpredictable nature of these factors and that contracts are written ex ante, the parties must set the price of the lease based on expected prices. Furthermore, given their opposed interests, price expectations are likely to differ.
Consequently, the inclusion of a contingency clause in the form of periodic price revisions is a highly valuable mechanism to resolve disputes and optimize the terms of the contract. In addition, in comparison to a fixed rent scheme, price flexibility protects landlords against upward price changes and tenants against downward ones. Thus, risk is reduced, negotiation is simpler and contractual costs diminish.

From the perspective of the bargaining mix, price revision can be a very useful compensation mechanism to align preferences and maximize value. For instance, tenants may offer a more frequent and/or variable price updating in exchange for a longer tenure and/or a lower initial price.

Limiting parties’ ability to update the rent during the duration of the contract and to freely determine a method for this purpose may generate pernicious effects. In the expectation of increasing prices, landlords might be reluctant to rent unless they can front-end load the expected rises to the nominal rent so that the present value of the contract under the regulation is equal or greater than that with free rent updates. Additionally, in this case, landlords have incentives to prefer shorter-term lessees, who are more likely to voluntarily terminate the contract earlier than stipulated, such as students and single youngsters, because they make an abnormal profit during the first years of the contract (Arnott, 2003). Conversely, lessees are aware that the longer they stay in the same dwelling, the lower is their real rent going to be. Therefore, they are incentivized to remain as long as possible in the same residence, even when their personal circumstances, such as job location or income, change (Arnott, 2003). The fact that a new, equivalent rent agreement would be more expensive reinforces this phenomenon. Thus, a side effect of limiting price updating is a reduction in tenants’ mobility, below the optimal levels. At the same time, this generates negative externalities to the labor market as some lessees may reject job offers in other locations to maintain their rental benefits. Other possible reactions of lessors are to reduce the duration of the contract so that it is sufficiently short to properly update the price to the market level and to curtail the maintenance of the residence within tenancies to cut costs and induce an early termination. In all these scenarios, both tenants and landlords would be harmed by suboptimal terms or diminished supply. Nevertheless, it is worth highlighting that long-term lessees may benefit from this measure when combined with a minimum duration of leases because they would be temporarily protected against sharp rises in rent that would force them to terminate the contract prematurely. That is, they would enjoy a greater security of tenure.

On the contrary, if prices are expected to drop, tenants would require a sufficiently low fixed rent to compensate for future fall in prices or a shorter than optimal duration of the contract to be able to renegotiate periodically. Again, both lessees and lessors suffer from suboptimal terms.

As a result, limiting price updating is detrimental for both parties as they are obliged to use inefficient terms (Arruñada, 2001). This may cause a decrease in the supply of rental housing and renters’ mobility, as observed in San Francisco between 1995 and 2012. In this case, regulation of rent rises reduced supply by 15%, diminished tenants’ mobility by 20% and likely drove market prices up (Diamond, Qian & McQuade, 2019).
In Spain, the rent can only be updated annually and its increase cannot be greater than the percent variation of the most recently published Consumer Price Index (CPI). In the event of improvement works and/or rise of the expenses relative to the maintenance and services of the dwelling, the rent can exceptionally be incremented up to a 20%. This exception aims at avoiding poor dwellings’ conservation but may incentivize the upscaling of residences in order to be able to rise prices. This phenomenon especially harms future low-income tenants because the supply of affordable rental housing diminishes in the long-term.

Thus, Spain limits price upgrading. This can damage the interests of both landlords and tenants. In light of the recent empirical evidence, this may reduce supply, place upward pressure to prices and reduce mobility.

### 3.3. Maximum security deposit

In most rental housing transactions, the parties suffer from asymmetric information. This occurs because it is complicated for landlords to identify the good, non-troublesome tenants. At the same time, it may also be complex for lessees to signal their quality ex ante. Namely, there is an adverse selection problem (Akerlof, 1970).

A good, non-troublesome lessee is characterized by complete compliance with the agreed terms. A bad one is defined by breaches of contract, such as not punctually paying the rent or the misuse or theft of the furniture and household appliances of the dwelling. The negative effects of these issues can be aggravated in contracts under slow, inefficient, *material justice* oriented jurisdictions (Arruñada, 2001).

Thus, given that all these potential disruptions bear costs, the difficulty to easily select a good lessee generates risk to the lessor. This situation may withdraw some landlords from the market, reducing its supply and efficiency. Consequently, one of the landlords’ main objectives when negotiating the terms of the contract is to minimize risk.

The inclusion of a security deposit in the contract allows lessors to screen the market in the search of good tenants and reduce their exposure to the bad ones. The clause works as a self-selection mechanism: only good tenants are willing to accept a relatively high security deposit because they are certain they are going to recover it. Accordingly, the more risk averse the landlord, the more valuable the dwelling and the less trustworthy the tenant, the higher the security deposit requested is expected to be.

As a result, freely determining the amount of the security deposit is not only beneficial for the lessors but also for the lessees, as they can signal their quality. This may be of capital importance for low-income tenants, who are the ones perceived as more risky by landlords.
In the Spanish case, a security deposit equivalent to one rent is mandatory and must be given in cash. Exceptionally, the parties may agree on additional warranty instruments, such as bank guarantees, but these cannot amount for more than the price of two months of lease. Besides, the sum cannot be updated during the first 5 or 7 years of the contract, depending on the legal nature of the landlord. After this period, the security deposit cannot exceed the amount of two rents either. Additionally, regional governments may oblige the lessor to lodge the amount in the administration’s account until the expiration of the contract.

These measures generate a homogenization of security deposits. This seriously hinders their use as a screening strategy to solve the adverse selection problem. Low-income tenants and landlords offering high value dwellings may be the most affected profiles since they are the most risky and the most risk bearing individuals. Hence, they are the most interested in exploiting all the signaling and screening tools available.

As a result, these rules obligate the parties to use inefficient terms, which may reduce supply, and place upward pressure on prices.

### 3.4. Restrictions on eviction processes

Contracts are valuable when the compliance with the terms can be enforced. Many different enforcement mechanisms exist (Arruñada, 2001). In relation to lease contracts, the judicial system of the country, a third party enforcement instrument, is the most commonly used in case of dispute.

Ex ante, both parties are willing to protect themselves against opportunism, hedge risk and maximize the value of the contract. Consequently, they crave for fast, efficient courts in case of litigation. The best case scenario would be that in which, in case of a breach of contract, a court rapidly enforces the agreed terms. Nevertheless, ex post, parties develop rent-seeking behavior and may be prone to exploit judicial system’s flaws and biases in order to expropriate contractual surplus (Arruñada, 2001). This opportunistic behavior is more likely to succeed in the case of an eviction request after the default of the tenant. For a diverse set of reasons, such as social pressure or the intention to be fair in specific circumstances, judges in this situation may favor the weaker, most vulnerable party. This is known as *material justice*. Thus, when faced with an eviction request, the court may prolong the sentence or even allow for the occupation of the dwelling.

This kind of sentences damage both legal certainty and economic efficiency (Arruñada, 2001) because they artificially create more risk to the parties, especially to lessors. Specifically, landlords are obliged to consider the possibility of terms’ enforcement failure and the consequent property occupation. Hence, they have to account for this potential additional costs when deciding to offer their dwelling for rent and setting the price.

Not only courts, but also policymakers may also fall in the same trap. In some countries, the eviction of tenants, especially if they are considered as vulnerable, is heavily restricted. For instance, France suspends
all evictions during winter and Greece forbids evicting citizens from their principal residence, what is known as the “Katseli law”. This rule is currently under revision.

The impact of all these sentences and legislations is not limited to isolated cases: there is a horizontal effect (Arruñada, 2001). The most pernicious consequences are borne by all the tenants with a similar risk profile because they may be deprived from the rental housing market or requested to pay a risk premium in the future to compensate for the additional risk they carry. In this manner, what appears to be fair turns out to be an unjust measure which harms social welfare. Paradoxically, the party more interested in protecting the interests of the lessor appears to be the lessee.

In Spain, the royal decree-law enacted forces courts to communicate the initiation of the eviction process to the social services. In the event that these identify the tenant as socially or economically vulnerable, the eviction process has to be suspended for one month if the landlord is a physical person or for three months if it is a legal person.

Furthermore, since the creation of the Affected by Mortgages Platform (Plataforma de Afectados por la Hipoteca - PAH) in 2009, a social movement against judicially ordered evictions has risen throughout Spain. This social organization plans and coordinates pacific demonstrations to block the evictions. According to PAH, between 2009 and March 2019 several thousands of evictions have been paralyzed by their actions. Some of these were evictions relative to rent outstanding payments.

Irrespective of the reasons for the eviction, failing to enforce the contractual terms or making it more costly harms the tenants who are pretended to be aided since they become far more risky to landlords. This may reduce supply, increase prices and, as a result, decrease social welfare (Mora, 2010).

### 3.5. Rental price benchmark

The significance of prices goes far beyond notifying the amount which has to be paid in exchange for the use of a dwelling. Prices play a key role in the economy: they facilitate the allocation of scarce resources, such as housing, in an efficient way (Hayek, 1945). In the rental housing case, they include an infinite amount of dispersed information (what is known as specific information) about the specificities of the dwellings offered in just one figure. This allows potential tenants to cheaply perform a preselection of offerings based on their preferences without the need to spend costly resources, such as time, into gathering information about each apartment. Thus, thanks to the value communication function of prices, searching and accumulating information about thousands of dwellings is not necessary: just with one number any individual is able to know the value of the offered asset. Accordingly, any measure limiting the free adjustment of prices undermines this essential function (Hayek, 1945).
Notwithstanding, do prices in the lease market reflect the real value of the assets? Although the rental housing market is not perfectly competitive, if its prices can freely adapt to changes in supply and demand, they can be considered to reflect the real value of the underlying assets. In other words, they represent tenants’ willingness to pay. Thus, they serve as a way to efficiently allocate dwellings to those who value them the most.

According to the advocates of a rental price benchmark, its introduction would make the market more transparent and help tenants identify and reject the landlords requesting an abusive rent. That is, it would solve a presumed market failure: a bubble. Nevertheless, any change in prices is normally the result of shocks in supply and/or demand: bubbles are rare and difficult to identify ex ante. Prices represent tenants’ willingness to pay: they are a true and fair reflection of individuals’ preferences given a limited stock of houses. Taking this into account, the price system is the best mechanism to efficiently allocate resources.

Furthermore, the way such a benchmark is constructed is far from trivial. Sttical aggregates, the use of general information, cannot include the infinite amount of specificities and the “particular circumstances of time and place” affecting each dwelling and individual (Hayek, 1945). The collection of past prices recorded in public databases cannot serve as a way to determine the correct market price of rents because they are unable, by construction, to take into account future marginal changes in each dwelling, landlord and tenant. For instance, last year’s average rent for a determined circumscription cannot include the value added by the recent construction of a park nearby, the opening of an organic supermarket and some new trendy restaurants around (Banzhaf & Mangum, 2019), a sudden reduction in the supply of rental dwellings nor an increase in the demand to live there.

In any case, the periodic publication of a rental price benchmark would not affect per se the rental housing market because the incentives of the parties would not be altered.

In the Spanish case, the recently enacted royal decree-law establishes the creation of the benchmark using information from the national tax authority, the land registry and the administrative registries of security deposits. The index is going to be published annually and is going to contain the average prices per squared meter for each census section, neighborhood, district, city, province and autonomous community. Moreover, to mitigate its inefficacy, the law entitles all regional governments to freely adapt the benchmark and to apply their own incentive policies within their competencies. Additionally, municipalities are authorized to grant a 95% discount on the real estate tax to those lessors offering their dwellings below an arbitrary value.

Considering the inherent imperfection of the mechanism, the application of any monetary incentive in the form of additional taxes or subsidies to those deviating from the artificially set price would drive the market to inefficiency. Landlords being levied more taxes would consider them as costs. Therefore, this situation would lead to three different consequences. First, prices would suffer upward pressure. Second, the potential impossibility to increase rents would transfer the burden to the other terms of the contract (Hayek, 1945).
That is, lessors would compensate the higher costs by toughening other clauses, such as tenure and security deposit. Additionally, incentives for appropriate maintenance may diminish. Ultimately, the penalty may cause a reduction in supply because of the reduced or negative profitability of leasing. Some landlords might be better off selling the dwelling or leaving it empty than renting it at an insufficient price to compensate for risk. Differently, lessors would be willing to reduce the rent if a sufficiently large subsidy was granted. It has to be emphasized that subsidies would be paid by all taxpayers, independently of their income and housing preferences, and excess demand could be generated. In this scenario of price distortion, dwellings would not be efficiently allocated. Lastly, in the absence of taxes and subsidies, prices are not expected to change.

As a result, the introduction of a rental price benchmark and complementary monetary incentives would distort prices, demand and supply. This leads to inefficiencies and reduces social welfare.

3.6. Maximum rental price

The creation of a rental price benchmark appears to be the first step towards the establishment of a maximum rental price, a measure which is also being discussed in Spain. Effectively limiting the prices of rents, the hardest regulatory policy, would exacerbate the pernicious effects of the combination of the rental price benchmark and monetary incentives.

As discussed, price rigidity vanishes the value communication function of prices. Consequently, prices do not signal the real market value of the dwellings because specific information such as materials’ quality, rooms’ distribution and subjective valuation is substituted by an artificial number determined with incomplete general information gathered by public administrations. Namely, good dwellings cannot efficiently signal their value over bad apartments in the same neighborhood, raising search and information costs for tenants. Therefore, it is likely that those valuing the most the apartments are not going to inhabit them, which means a suboptimal allocation of resources. This phenomenon decreases lessees’ consumer surplus (Bulow & Kemper, 2012). Glaeser and Luttmer (1997) provide empirical evidence from New York City to this point.

Furthermore, if landlords cannot sufficiently compensate the decrease in profitability and screening ability by toughening the other terms of the contract and/or reducing the maintenance of the dwelling and have better alternative uses for the asset, such as selling it for owner-occupation, setting a maximum rental price decreases supply. There is a substantial body of literature supporting this, both theoretically (Downs, 1988) and empirically (Sims, 2007). The final result is an inefficient market and suboptimal social welfare.
4. Conclusion

After the analysis conducted, based on economic principles and empirical evidence, it can be stated that establishing (1) a minimum tenure; (2) a limitation on price updating; (3) a maximum security deposit; (4) restrictions on eviction processes; (5) a rental price benchmark and (6) a maximum rental price is likely to result into an increase in prices and/or a decrease in the supply of dwellings available for rent, specially for low-income tenants, among other pernicious effects. These outcomes decrease social welfare.

Why is contractual regulation more detrimental for financially stressed tenants? The inclusion of contractual restraints harms all parties because they oblige everyone to use inefficient terms. Nevertheless, low-income individuals are the most severely damaged because they constitute the riskiest type of lessees for landlords: they are more likely to be temporary employees and keep shifting jobs (Van Lancker, 2012), which causes income instability; tend to spend a much larger share of their disposable income on rent (OECD, 2019) and are usually more protected against evictions, like in Spain. These facts imply that low-income tenants entail a higher risk of default for which landlords have to be compensated with shorter tenures or more guarantees. In other words, for them, the adverse selection problem is more intense. For this reason, they can be considered as a segregated, more complex and imperfect market. Contractual regulation undermines the mechanisms that lessors can use to hedge against this adverse selection problem, incentivizing them to abstain from contracting with high risk profiles. As a result, contractual rigidity especially hinders the access to rental housing to those tenants perceived as potentially more conflictive. That is, the low-income ones.

The fact that contractual regulation incentivizes the discrimination of low-income individuals and complicates their access to housing is paradoxical given that these rules are often enacted to aid them. Indeed, it seems straightforward that, when market intervention complicates the screening and eviction of tenants, the preference of the landlords remaining in the market for higher income lessees is going to increase. Accordingly, in the absence of price limitations, the will to attract more sophisticated tenants may incentivize lessors to upgrade and rehabilitate their properties. Consequently, low-quality housing stock may even diminish for a long period of time (Arnott, 1995). Diamond, Qian and McQuade’s (2019) empirical research found that rent control significantly reduced this type of rental housing in San Francisco. Subsequently, over-protecting tenants is detrimental for both the current and the future ones: it produces a horizontal effect. Thus, future lessees, specially those with low-income, are the ones more interested in contractual freedom to allow landlords to hedge risk.

The inefficiencies caused when combining at once all the discussed measures are greater than the sum of their individual effects. The rationale behind this phenomenon is that it is more difficult or almost impossible to offset the inefficiencies caused by one specific measure using the other terms of the contract, such as asking for a higher rent or security deposit or reducing the tenure to hedge risk. The most salient
consequences are lower supply and reduced dwellings’ maintenance. Other, less prominent distortions discussed are: residence upscaling, lower renters’ mobility, greater discrimination of tenants, discouragement of new rental housing units construction and motivation to convert rental to owner-occupied housing. Again, all these effects are consequence of the impossibility to freely set prices and use all the available mechanisms to hedge against the risks of renting property.

Furthermore, it has to be highlighted that the impact of all the inefficiencies generated may go far beyond the rental housing market and affect the whole functioning of the economy by diminishing labor mobility (Barceló, 2006). Higher home ownership rates are associated with higher unemployment because of the lower labor mobility. That is, owning a dwelling increases the costs of moving from areas with an excess supply of labor to those with a shortage. Thus, rental housing market intervention generates negative externalities in the labor market and the entire economy because it incentivizes home ownership. Blanchflower and Oswald (2013) provide empirical evidence from the US. This pernicious consequence may have a considerable impact in Spain, where house tenancy rate was equal to 76.7% in 2017, according to the National Statistics Institute (Instituto Nacional de Estadística - INE). This exceptionally high home ownership rate is fundamentally attributed to the strong rent control started in 1946 (Mora, 2010).

The negative effects of contractual regulation not only affect some individuals but the society as a whole. The undersupply of dwellings for rent and the upward pressure to prices generate deadweight losses which, at an aggregate level, have an impact for the entire society in terms of social welfare. Andersson and Söderberg (2012) quantify the increase in social welfare directly attributable to the total deregulation of the Swedish rental housing market at 20 billion SEK. Additional gains arising from the removal of the indirect effects of contractual regulation, such as diminished labor mobility, may also accrue. Besides, incentives to build more rental dwellings, which would also raise welfare, may also follow as a consequence of the possibility to screen tenants and the temporary higher profitability.

Differently, Arnott (2003) argues that regulating the content of lease agreements only within tenures but not between them, as it is common nowadays, may increase the aggregate social welfare if the gains arising from a higher security of tenure outweigh the efficiency losses generated by such a policy. Nevertheless, he acknowledges that a positive net effect can only be obtained if the interventions are correctly designed and depending on the specific characteristics of the housing market of the territory, the well-functioning of its legal system and the social value artificially attributed to improving the security of tenure. The first conditions explicitly state the complexity of accurately defining a regulation that minimizes the inefficiencies it produces, as manifested by the several side effects discussed throughout all the paper, while the latter implies moving from a positive to a normative economics examination. Thus, it is difficult to argue that such an optimal policy can be effectively designed and implemented and that the deadweight loss it would generate would be smaller than the subjectively valued increase in security of tenure. Additionally, the recent
empirical research conducted by Diamond, Qian and McQuade (2019) suggests that the long-term effects of this kind of policies are detrimental.

As a result, which reforms should be performed in order to increase social welfare, especially in Spain? To boost welfare, rental housing supply has to increase. To achieve this goal, contractual regulation has to be repealed. The ability to freely negotiate the contract allows both parties to use efficient terms and landlords to screen the market in order to minimize their exposure to bad tenants. Moreover, being able to charge market prices and reduce risk incentivizes the conversion and building of rental units until the market clearing price and quantity, an efficient equilibrium, are achieved. Nevertheless, given the inherent inelasticity of housing supply and the relatively high costs of construction, legal certainty is essential to optimize this increase: expectations that rent controls can be enacted again in the future may deter real estate developers from initiating new projects. Softening building requirements may also facilitate and accelerate the increase in supply, specially in dense cities. Similarly, an efficient judicial system is also required to minimize risk and maximize social welfare because slow, material justice oriented courts produce uncertainty and potential costs to lessors in the event of eviction petitions. For a given demand, these measures would make rents more affordable. At the same time, they would facilitate rental housing access to low-income tenants.

Simply put, contractual freedom, legal certainty, ease of construction and judicial efficiency are the key drivers for an efficient rental housing market, which maximizes social welfare.
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