RESEARCH NOTE

Rent controls: The next mistake in housing policy

David Law[*]

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Introduction

Pressure to intervene in the rental market is growing. The government's new housing package, announced in March of this year, will increase rents and reduce the supply of rental accommodation to the detriment of many. Understandably, there is significant concern about this prospect.

Green Party MP Chloe Swarbrick recently suggested that rent controls should be considered to keep rents in check, and the Finance Minister is at this stage not ruling them out. In fact, in 2013 when vying for the Labour Party leadership he proposed introducing rent controls, noting that if elected leader he would introduce a private members bill to stabilise rents in Christchurch.

However, the introduction of rent controls would only exacerbate problems in the rental market and are a recurring policy mistake. This paper explains the reasons rent controls should be avoided, with reference to some recent empirical studies on their effects. The paper then outlines some of the previous policy choices that have been made with respect to housing, as well as their unintended but obvious consequences, that risk leading to the introduction of rent controls.

Why avoid rent controls

Rent controls come in various forms. They can cap the rent charged or, more commonly, rent increases during a tenancy. To be effective, they are usually paired with restrictions on eviction.

The standard economic model of rent controls

The consequences of rent controls are straightforward to ascertain with standard supply and demand analysis. Figure 1 depicts the rental accommodation market in New Zealand with the demand for rental accommodation at any given price represented by the curve (D). The supply of rental accommodation at any given price is represented by (S_2) and the market clearing rental price and quantity are (P_2*) and (Q_2*), respectively. The introduction of a price ceiling – the maximum rental price permitted (P_{max}) is illustrated by the green horizontal line.

The price ceiling is set below the previous market clearing price of (P_2*), otherwise it would have no effect. At the lower price of (P_{max}), fewer units of rental accommodation are supplied to the market than before; at the same time, they are in greater demand. A shortage of rental accommodation now exists and is the difference between (Q_D) and (Q_S).

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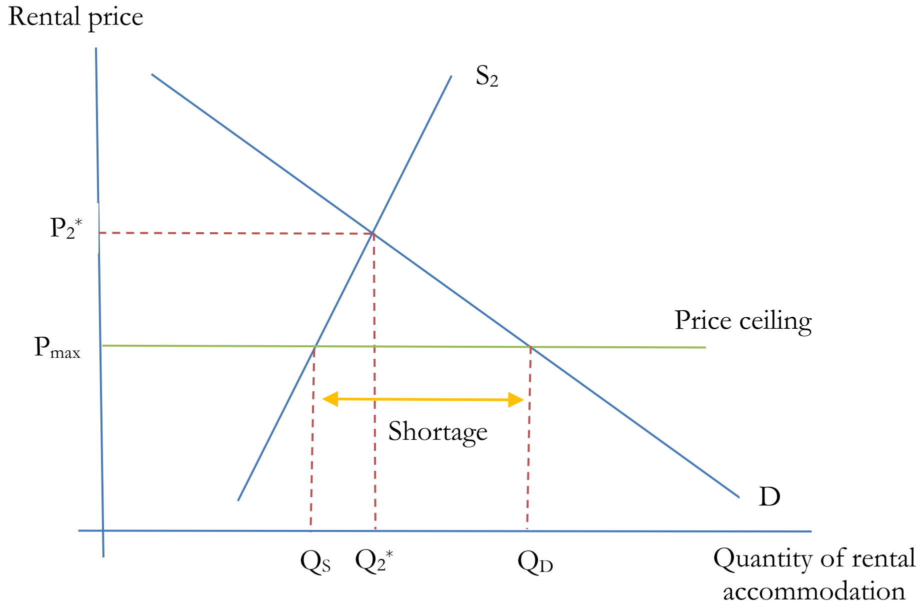
* Dr David Law is a Senior Fellow at The New Zealand Initiative. All errors and omissions are the sole responsibility of the author.

Figure 1: Implementing rent controls



Unlike other forms of price ceilings, where resulting queues work on a first-come-first-served basis, rent controls favour sitting tenants with rents below market rates on rent-controlled units. For uncontrolled rental accommodation, such as with new builds or when a tenancy changes hands, rents can skyrocket as excess demand for rent-controlled accommodation spills over to uncontrolled accommodation.

The problem may be exacerbated if new supply of rental accommodation is reduced. Developers may be less inclined to build new housing, even when new buildings are not subject to existing regulation, as the possibility of future profit-curbing legislation makes building new residences less appealing.

Misconceptions

A minority claim the standard economic analysis of rent controls is inadequate. For instance, a blog by J.W. Mason which is receiving some attention from proponents of rent controls in New Zealand, contends this standard supply and demand analysis does not hold in the real world.[1] However, this opinion is based on a misunderstanding of what the standard economic model of rent control predicts.

Mason argues that several recent studies find rent controls have little to no effect on new housing construction and overall housing supply, and that rent controls were effective at holding down rents.

However, the model outlined in Figure 1 does not make predictions about overall housing supply, but rather the supply of rental accommodation. In fact, most of the empirical studies Mason cites find that rent controls reduce the supply of rental accommodation, precisely as predicted. Indeed, some of these studies are discussed in more detail below in the evidence against rent control.

Similarly, it is no surprise that rent controls limit rent increases on rent-controlled accommodation. Setting a maximum rental price below the market level is illustrated in Figure 1 and is what drives the model. However, the resulting shortage can lead to higher rents than would otherwise have been the case for uncontrolled accommodation.

In addition, Mason asserts that the goal of rent control goes beyond affordable housing. It is also about preserving the interests of long-term tenants to remain in their homes, and that there is social interest in maintaining income-diversity and stability in neighbourhoods. However, there is evidence that it is in fact older, higher income residents who benefit most from rent controls.

Similarly, with respect to security of tenure of residents, this again misses one of the key conclusions of the standard economic model of rent controls. When the tenure of some residents is increased, it is at the expense of shortages in the rental accommodation market. Other prospective tenants who may be in greater need of affordable housing face queues, sometimes for decades, or miss out altogether. Further, and as discussed in more detail below, although studies do indeed find reduced mobility from the imposition of rent controls, this is highly inefficient.

So, Mason's contention that economists are changing their views on rent control based on new evidence is wrong. The relatively new evidence he cites is entirely consistent with economic theory, despite his claims to the contrary. It is no wonder that 95% of top economists agree that rent controls harm the supply and quality of rental accommodation.[2]

International evidence

In fact, economic research has done an excellent job of highlighting the potential negative consequences of keeping rents below market rates. As early as 1946, Milton Friedman and George J. Stigler argued that capping rents would lead landlords to sell their rental properties to owner occupants so that they could still earn the market price for their asset.[3] And in well-functioning rental markets, not all renters want to be owner-occupiers.

Rent controls can also reduce the quality of rental accommodation. Landlords unable to recoup costs by raising rents may not invest in maintenance.[4]

A mismatch between tenants and rental accommodation as well as reduced mobility can also result from rent controls. Tenants who have been able to secure rent-controlled accommodation may not want to move in the future, even if their housing needs change, since they would have to give up their rent control and potentially pay more.[5] As a result, families may end up living in small apartments while empty nesters live in large homes they do not need and people do not move to take up better employment opportunities.

More recent studies have analysed data spanning periods of significant change in rent control laws to shed additional light on how rent controls affect tenants, landlords and the broader housing market. Two studies of US cities, in particular, highlight the high costs of rent controls.

The first looked at San Francisco, which introduced rent controls in 1979 on all buildings with five or more apartments and consisted of regulated rent increases within a tenancy, linked to inflation.[6] New construction was exempt – as were smaller multi-family buildings. This exemption was lifted in 1994 but only affected smaller buildings built before 1979 (the 1979 law only applied to properties built before 1979). Similar properties built since 1980 were treated differently, forming the basis of a control group for study.

The study found that the beneficiaries of rent control were significantly less mobile than their control group counterparts. The former were 19 percent less likely to have moved to a new address 5 to 10 years after the rent control changes. Further, the impact on the likelihood of those covered by rent controls leaving San Francisco altogether was similar. In addition, landlords affected by rent control reduced the supply of rental accommodation by 15 percent, likely driving up market rents in the long run.

The second US study was in Cambridge, Massachusetts, where stringent rent controls were unexpectedly eliminated in 1995.[7] These had been in place for approximately 25 years and covered all rental units built prior to 1969, with caps on rent increases and restrictions on removing rental accommodation from the market. Just before rent controls were eliminated, rent-controlled accommodation rented for around 40 percent below the price of nearby non-controlled properties.

The study found that post-elimination, decontrolled properties' market values increased by 45 percent. Values also increased for previously uncontrolled neighbouring properties with price appreciation being significantly greater for properties that had more exposure to formerly controlled neighbours. Indeed, removing rent control boosted Cambridge's property values by $2 billion between 1994 and 2004. However, only $300 million of this was accounted for by the direct effect of decontrol on formerly controlled units. In short, rent-controlled properties create substantial negative externalities on the nearby housing market.

Finally, evidence suggests rent controls can actually have a regressive effect, rather than help low income households. A Swedish study,[8] for example, examined the distributional effects of rent control using a dataset that included the characteristics of those who received rental apartments between 2011 and 2016 in central Stockholm, allocated through a centrally managed queue.

The authors found that individuals who received rent-controlled apartments earned 30 percent higher incomes on average. Further, the most heavily subsidised apartments had older tenants with substantially higher incomes compared to tenants who had received less subsidised apartments.

The path to rent controls

Over the past two decades, real house price growth in New Zealand has been among the highest in the OECD. New Zealanders spend significant proportions of their disposable income on housing costs. It is therefore no surprise that the issue of housing affordability attracts the interest of policymakers.

The new housing policy package

The latest in a long list of policy interventions is the government's housing package announced on 23 March. The package aims to "increase the supply of houses and remove incentives for speculators, to deliver a more sustainable housing market"[9] and consists of three key elements:

1. **Extending the bright-line test from 5 to 10 years.** This test determines which investment properties will be subject to tax on any capital gains resulting from their sale. This applies specifically to properties bought and sold within the specified time period. Extending the bright-line test therefore has the effect of increasing the tax paid on capital gains on the sale of investment properties.
2. **Closing a tax 'loophole'.** Residential property investors can no longer deduct interest on mortgages from rental revenue for tax purposes. This was in no way a loophole. Interest on borrowing is the single largest expense for many landlords, so this policy will significantly increase their tax burden.
3. **Allocating an additional $3.8 billion to the Housing Acceleration Fund.** The fund aims to increase land available for housing development, help provide the infrastructure needed for that

development, and deliver a wider mix of affordable housing. Details on how and when these aims might be achieved, however, are limited.[10]

Unfortunately, the package does little to address the underlying reasons for relatively high and rising house prices and falling housing affordability. Poor problem identification increases the risk of policy failure and unintended, though in this case predictable, consequences for the rental market.

Likely effects of the new housing policy package

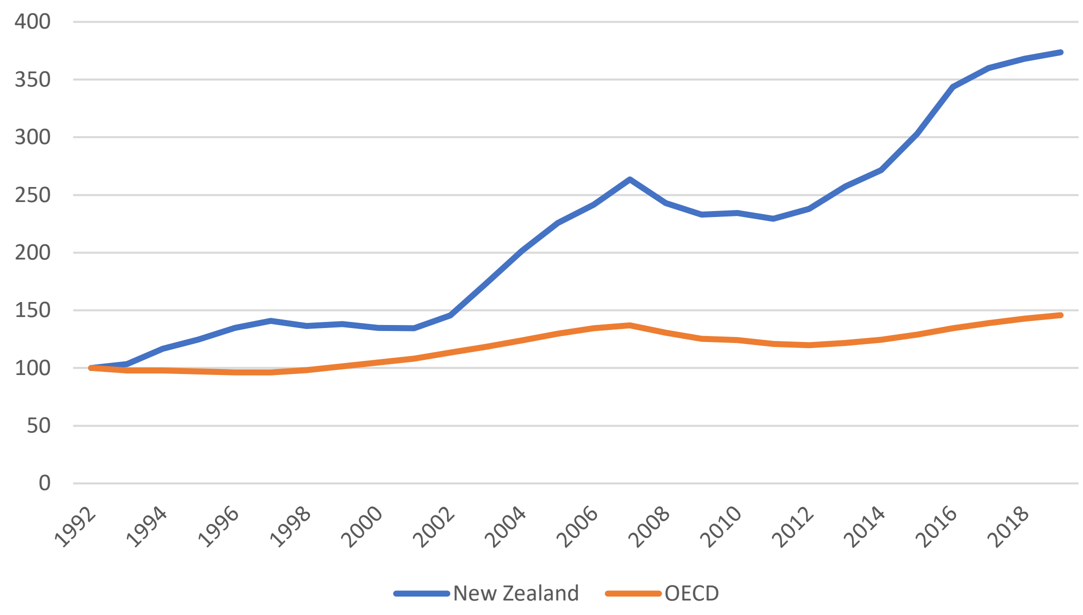
The architects of the government's new housing package probably aimed to stabilise house prices, improve housing affordability, and facilitate home ownership. However, they appear to be struggling with proper problem identification, which means policy interventions may not meet their objectives.

Late last year, Prime Minister Jacinda Ardern claimed that migration was the cause of increasing house prices. That was despite the border being closed and net migration having been close to zero for many months.[11]

With the new housing package, the government's attention is on what it terms property 'speculators' who they also believe are driving up house prices and limiting the ability of first home buyers to enter the housing market. In this context, a 'speculator' is anyone who voluntarily invests their capital to provide rental services to a willing buyer in a mutually beneficial trade.

However, most economists highlight supply constraints as the major concern. For example, the *Resource Management Act*, urban planning rules, and the incentives faced by local councils constrain supply and increase the time and cost of housing development. New Zealand also has stringent restrictions on foreign direct investment, which limits construction. On top of this, accommodative monetary policy in response to Covid-19 has further fuelled housing demand.

Figure 2: Real house prices, 1992–2019 (indexed to 100 in 1992)



Source: OECD Statistics.

The consequences of poor problem identification in recent decades are readily apparent in a myriad demand-side measures, including:

- ending depreciation on housing for tax purposes;
- imposing stringent loan-to-value ratio restrictions, which are now particularly onerous for investors;
- imposing and then extending the bright-line test;
- ending the ability to offset losses from rental activities against other forms of income for tax purposes;
- banning foreigners from buying most types of homes in New Zealand; and
- imposing new regulatory burdens on landlords.

Despite these measures, real house prices in New Zealand have increased at a remarkable pace (see Figure 2). In the last year alone, house prices increased by over 20 percent.

The new housing package is also mostly about trying to dampen housing demand from property investors by increasing the tax burden they face and increasing the tax revenue collected by government. There may be a short-term reduction in the rate of house price growth and an improvement in the ability of first home buyers to enter the housing market. However, even if this happens, with increased costs of providing some types of housing and little being done to increase supply, it seems unlikely these effects would last long.

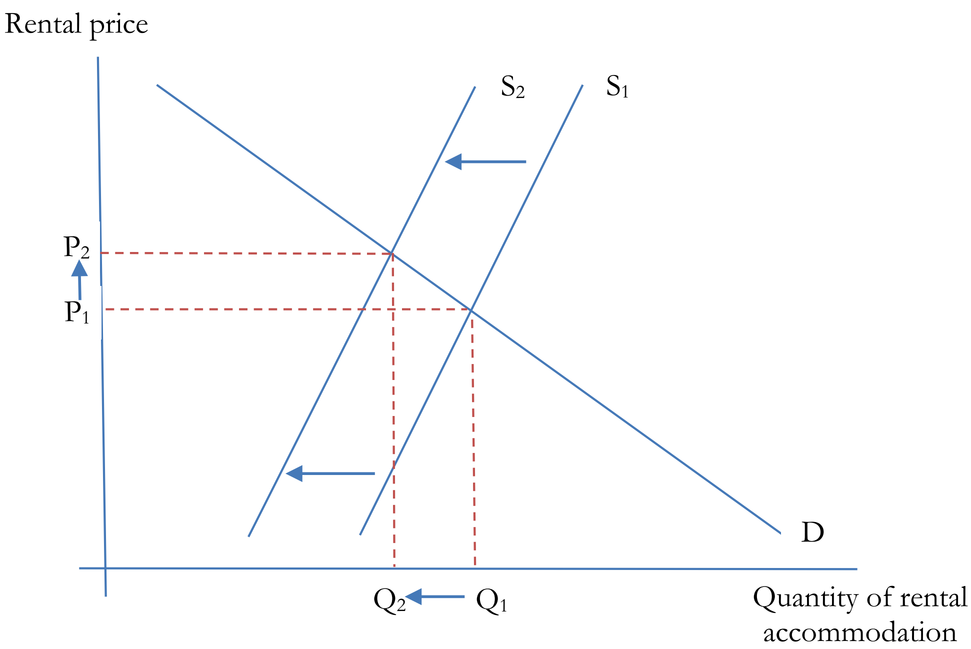
It is difficult to be more precise and predict some of the likely distributional consequences of the new housing package as it appears little background analysis was undertaken. For example, it would be useful to understand the degree to which the current rental stock and owner occupied houses are substitutes, how many property investors will be affected, and to what degree their tax liabilities will increase. In addition, we need to know how many tenants are in a position to buy their own home if some investors are now more motivated to sell, or will large institutional investors instead step in. However, one area where the consequences of the housing package are easier to predict is in the market for rental accommodation.

Unintended but obvious consequences

Two components of the new housing package are particularly problematic for the rental market and will make renters worse off. These are extending the bright-line test and removing interest deductibility from rental revenue for tax purposes.

Both changes considerably increase the cost of providing rental accommodation. For example, under the second component, a landlord who owns a million-dollar rental property with an $800,000 mortgage paying 3 percent interest per annum would find herself having to pay an additional $9,360 per annum in tax if she were at the top marginal tax rate. Interest rates are particularly low now. If they were to rise, even by a modest 2 percent, this landlord’s annual tax liability would be $15,600 higher than it was before the new housing package.

Figure 3: Increasing costs in the rental accommodation market



The consequences of an increase in costs in a market are straightforward to ascertain with standard supply and demand analysis. Figure 3 depicts the rental accommodation market in New Zealand, with the demand for rental accommodation at any given price represented by the curve (D). The supply of rental accommodation at any given price before the introduction of the housing package is represented by (S_1) and the market clearing rental price and quantity are (P_1) and (Q_1), respectively.

Increasing costs for landlords means that at any given rental price, less rental accommodation will be offered to the market – supplying rental services is after all voluntary. This is represented with a move of the supply curve to the left, from (S_1) to (S_2). The result is that rents go up, from (P_1) to (P_2), and the amount of accommodation rented falls from (Q_1) to (Q_2).

There are potential complications. Proponents of the new housing package may argue that the increase in rents described above would be mitigated by reduced demand as renters purchase their own homes. However, it is not clear how many renters are actually in a position to do this.

Analysis using data from the Survey of Family, Income and Employment (SoFIE) previously looked at precisely this question. Based on individuals' incomes, assets and liabilities, interest rates, the region in which they lived and house prices in those regions, only 31 percent of those renting could afford to service a mortgage on a lower-quartile priced house without payments exceeding 30 percent of their gross income.[12] Of course, since these people were observed renting, despite apparently being able to afford to purchase a house, it is reasonable to assume that they preferred to rent.

Unfortunately, the data used in this analysis was for 2008. Since then, interest rates have fallen, increasing affordability; on the other hand, house prices are much higher, having the opposite effect. It is a pity the analysis has not been repeated more recently. Nevertheless, it seems unlikely that enough renters would be induced to buy their own homes to avoid increasing rents.

Conclusion

The government's new housing package was no doubt devised with good intentions. However, by focusing on measures to dampen housing demand, particularly from those who provide rental accommodation services, rather than the key drivers of inadequate housing supply, it is likely to have little effect on housing affordability in the long run.

Nevertheless, it will have unintended but obvious consequences. Because the package increases the costs of providing rental accommodation, it is likely rents will increase and the supply of rental accommodation will decrease. This increases the risk of further policy intervention, particularly with rent controls – an intervention that almost all economists reject.

If rent controls are in our future, we can expect even greater shortages of rental accommodation as supply is cut back – and what is on offer may be of lower quality. Mobility will fall – as will the amenity value of our neighbourhoods and cities. On top of that, rent-controlled accommodation may not go to those who need it the most.

When there are fewer places to rent available at the going price than there are people who wish to rent properties at that price, and prices cannot adjust, some mechanism other than prices has to ration scarce rental spaces among competing potential tenants. If there are already concerns that landlords prefer tenants who they see as being less risky, with potentially discriminatory consequences, rent controls will worsen an already bad situation.

High rents and poor experiences for renters are a consequence of shortages of rental properties. Expanding the potential supply of rental properties so that landlords face stronger competition for tenants would alleviate the housing shortage and facilitate better functioning rental markets.

Endnotes

[1] J.W. Mason, “Considerations on rent control,” Blog post (14 November 2019).
[2] Chicago Booth, “Rent Control,” Website (7 February 2012).
[3] Milton Friedman and George J. Stigler, “Roofs or Ceilings?: The Current Housing Problem” (Foundation for Economic Education Inc. 1946).
[4] See, for example, Anthony Downs, “Residential Rent Controls” (Washington, DC: Urban Land Institute, 1988) and David P. Sims, “Out of Control: What Can We Learn from the End of Massachusetts Rent Control?” *Journal of Urban Economics* 61:1 (2007), 129–151.
[5] See, for example, Wing Suen, “Rationing and Rent Dissipation in the Presence of Heterogeneous Individuals,” *Journal of Political Economy* 97:6 (1989), 1384–1394; Edward L. Glaeser and Erzo F.P. Luttmer, “The Misallocation of Housing under Rent Control,” *The American Economic Review* 93:4 (2003), 1027–1046; David P. Sims, “Rent Control Rationing and Community Composition: Evidence from Massachusetts,” *The BE Journal of Economic Analysis & Policy* 11:1 (2011), 1–30; Jeremy Bulow and Paul Klemperer, “Regulated Prices, Rent Seeking, and Consumer Surplus,’ *Journal of Political Economy* 120:1 (2012) 160–186.
[6] Rebecca Diamond, Tim McQuade, and Franklin Qian, “The Effects of Rent Control Expansion on Tenants, Landlords, and Inequality: Evidence from San Francisco” (National Bureau of Economic Research, 2019).
[7] David H. Autor, Christopher J. Palmer, and Parag A. Pathak, “Housing Market Spillovers: Evidence from the End of Rent Control in Cambridge, Massachusetts,” *Journal of Political Economy* 122:3 (2014), 661–717.
[8] Herman Donner and Fredrik Kopsch, “Who Benefits from Rent Control? Socio-Economic Determinants of the Rent Subsidy” (Stanford, California: Stanford University, 2021).
[9] Beehive, “Govt housing package backs first home buyers,” Press release, Website (23 March 2021).
[10] Ministry of Housing and Urban Development, “The Housing Acceleration Fund,” Website.
[11] David Law, “Misdirection on Housing Affordability Unhelpful” (Wellington: The New Zealand Initiative, 2020).
[12] David Law and Lisa Meehan, “Housing Affordability in New Zealand: Evidence from Household Surveys,” Working Paper 13/14 (Wellington: Treasury, 2013).

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