RENT CONTROL: A PROPOSAL FOR REFORM

*Edward Iacobucci**

Le contrôle des loyers est une question fort controversée dans les domaines universitaire et politique. L'auteur de cet article examine trois approches distinctes qui ont été adoptées par des commentateurs : la vision libertarienne embrassée par Epstein; le rapport entre le foyer et l'indentité individuelle analysé par Radin; le bien-être économique. Dans cette dernière perspective, l'auteur insiste tout particulièrement sur le fait que le contrôle des loyers peut remplacer la conclusion de contrat à long terme. L'auteur propose ensuite une réforme du contrôle des loyers qui essaie d'aborder les préoccupations mises en évidence par les trois approches. Le régime proposé libère le prix des loyers payés par les locataires qui s'installent dans un appartement, tandis qu'il permet l'augmentation des loyers payés par les locataires qui continuent d'occuper un appartement, et ce, selon des taux pratiqués sur le marché et fixés par un organisme gouvernemental. Enfin, l'auteur propose un plan pour faire la transition du régime actuel de contrôle des loyers en Ontario au régime proposé.

Rent control is a matter of considerable academic and political controversy. This article explores three distinct approaches that have been taken by commmmmentators: the libertarian view espoused by Epstein; the connection between home and personhood analyzed by Radin; and the economic welfare approach. Within the latter perspective, this article places particular emphasis on the role of rent control as a substitute for long-term contracting. The article then proposes a reform to rent control that attempts to address concerns raised by the three approaches. The proposed regime decontrols rents for tenants moving into apartments, while rent in occupied apartments rises at market rates set by a government agency. The paper further suggests a transition scheme to move from present Ontario rent control rules to the proposed regime.

* B.A. (hons.) (Queen's), M. Phil. (Oxon), LL.B. Candidate, University of Toronto. I wish to thank Professors Jim Phillips and Arnold Weinrib for comments on an earlier draft. I also wish to thank Professor Michael Trebilcock for his comments and his special support and encouragement.

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I. Introduction

Rent control is a matter of considerable controversy among commentators from a variety of disciplines, including economics, philosophy and urban planning. While there are opposing views among philosophers and urban planners about the desirability of rent control, economists tend to view it as unjustified. The purpose of this paper is to survey and assess the literature on the debate over rent control, as well as to extend that debate.

There are essentially three approaches to the analysis of rent control that the paper will survey. One is the libertarian approach espoused by Epstein.[1] He suggests that rent control is a 'taking' of private property without compensation by the government for private purposes, and is thus unconstitutional (at least in the United States). His paper, as well as various critiques of his position, will be discussed first. A second approach is offered by Radin.[2] She suggests that some forms of property are integral to one's personhood and thus should not be fully commodified. Finally, the economic welfare approach (utilitarian approach) to rent control will be addressed. Various welfare advantages and disadvantages of rent control will be discussed.

This paper concludes that a moderate form of rent control may be justified. A proposed rent control regime will be outlined and analyzed from all three of the perspectives discussed above. The analysis will conclude that it is plausible to believe that the proposed system is desirable from a welfare and a personhood perspective, and adequately addresses the concerns of the libertarian. The paper will conclude by briefly describing the current rent control regime in Ontario, and outlining the optimal transition policy to the proposed regime.

II. The Libertarian Approach

Libertarians, such as Richard Epstein, are typically opposed to rent control.[3] Epstein states that what for him began as scepticism of rent control has "ripened into overt hostility."[4] The essential reason for this is simple: libertarians view rent control as an illegal confiscation of property from landlords without compensation. In particular, Epstein points to the American Constitution, which provides, "nor shall private property be taken for public use, without just compensation,"[5] as legal support for his claim. Epstein contends that this clause raises three questions explicitly, and one by implication. First, has private property been taken? Second, was it taken for public use? Third, was the owner of the property justly compensated? Fourth, by implication, was the taking justified under the 'police power' of the U.S. Constitution? For Epstein the answer to the first question is yes, while the latter three questions are all answered in the negative.

Epstein states that a landlord who leases out a property that she or he owns in fee simple has part of his or her reversion interest 'taken' if rent control is imposed.[6] He states

[1] R.A. Epstein, "Rent Control and the Theory of Efficient Regulation" (1988) 54 Brook. L. Rev. 741.

[2] M.J. Radin, "Residential Rent Control" (1986) 15 *Philosophy & Public Affairs* 350.

[3] See *supra* note 1.

[4] *Ibid.* at 742.

[5] U.S. Const. amend. V.

[6] After rent control is in place, this claim is weakened as the current owner will have knowledge of the restrictions on the building she has purchased and will have discounted the purchase price accordingly. Epstein replies that when rent control was originally imposed, it was illegal as the owners at that time had property improperly confiscated. Thus rent control cannot be legally imposed.

that by compelling a landlord to renew a lease at a price determined by the government,

> Rent control statutes operate to take part of the landlord's interest in his reversion and to transfer it to the tenant....The coerced renewal of a lease under the rent control statutes is hardly voluntary, but it is most surely a transfer from landlord to tenant. Thus, there is a "taking of private property" both for the student of ordinary English and the conveyancing master.[7]

Epstein then submits that the taking is best characterized as one for private, not public, use. Rather than taking property for use by the general public, rent control takes property for the use of specific tenants to the exclusion of others. For him, this taking for private use suffices to render rent control unconstitutional. However, admitting that the public use aspect of rent control may be more complicated than this simple characterization (for example, there may be an 'indirect public benefit' from rent control), and that the public use clause has been essentially read out of the U.S. Constitution,[8] Epstein also considers whether just compensation has been paid to the landlord. He states:

> Every rent control statute has only one raison d'être — to insure that the landlord's rent is kept below the fair market rental of the property.[9]

Thus, according to Epstein, "[r]ent control statutes *never* provide just compensation to the landlord."[10]

Finally, Epstein analyzes rent control under the police power implicit in the American Constitution. He concludes that rent control is not justified under this power. He states:

> Even if we assume that the state police power reaches ventilation, sanitation, and fire prevention, it is still difficult to include the identity of the tenant, or the amount paid to the landlord within the health and safety category....How are health or safety improved if the landlord is stripped of the financial resources that are necessary to comply with applicable health and safety regulations?[11]

This analysis leads Epstein to conclude that rent control statutes are unconstitutional in the United States. Rent control is an unjustified taking of private property for private use without fair compensation for the property so taken.[12]

While the specific constitutional law aspects of Epstein's analysis are confined to the U.S.,[13] his thesis has general significance for those concerned about the effects of rent

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[7] *Supra* note 1 at 744-45.

[8] See *Hawaiian Hous. Auth.* v. *Midkiff*, 81 L. Ed. 2d 186 (1984).

[9] *Supra* note 1 at 746.

[10] *Ibid.* at 747.

[11] *Ibid.* at 747-48.

[12] Epstein acknowledges that the case law in the U.S. opposes this view. The point was originally decided in *Block* v. *Hirsh* 41 S. Ct. 458 (1921)[hereinafter *Block*]. It was held in that case that rent control was not an unconstitutional taking of property. Rent control was deemed a justified response under the police power to a housing crisis in Washington as the result of the First World War. Furthermore the statute provided that landlords would receive a "reasonable return," and the Court held that this statute was therefore analogous to equally constitutional usury laws (at 460).

[13] Note, however, that it has been argued in Canada that rent control violates section 7 of the *Charter of Rights and Freedoms*, Part I of the *Constitution Act, 1982* being Schedule B to the *Canada Act 1982* (U.K.), 1982, c. 11 [hereinafter the *Charter*] by interfering with landlords' rights to liberty and security

control. If it is indeed a taking without compensation, governments in democratic, market societies should be reluctant to impose rent control. In my view, however, Epstein's analysis has significant weaknesses.

First, rent control may be characterized as simply one type among many types of regulation of property. As Becker points out:

> *[F]ee simple absolute* is a misnomer; it is neither simple nor absolute....It is not absolute because the central incidents of ownership are always conditional....[14]

Because ownership of property is constrained in many ways, such as taxation, rules against perpetuities, building standards, etc., the owner of rental units is aware that his or her ownership is subject to regulation.[15] Thus title to rental units does not include the right to be free from various forms of regulation, including some forms of rent control. If the government imposes rent control, then, it is not taking something from the landlord, since the landlord's title does not bestow immunity from this interference in the first place.[16] Epstein observes that, "[a] statute which provides for a $1.00 per month rent for all apartments would be struck down, even today, as confiscatory."[17] He views this as evidence that there is a limitation on the power of the state to regulate. While this may be true, the following is clear: whether or not a rent control statute is confiscatory is a matter of degree. Epstein concludes that rent control that restrains landlords from charging market price is illegal, but this need not be true. Some moderate level of rent control may be viewed as a form of taxation well within the government's scope to regulate property.[18]

Second, Epstein errs when he states that rent control statutes by definition require the setting of rents below market levels and thus can never fairly compensate landlords. For example, it is arguable that rent control which allows landlords to earn a competitive rate of return justly compensates landlords. A Commission of Inquiry into Residential Tenancies in Ontario, chaired by Stuart Thom, concluded that rent increases should be set at levels which allow landlords to earn a fair market return, as determined by reference to the return to comparable investments with similar risks.[19] While landlords are constrained in the rental price they may charge, they are compensated for this constraint by earning a competitive level of rents. This system, while entailing rent control, fairly compensates landlords.

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of the person. This argument was rejected in *Haddock* v. *Ontario (Attorney General)*, (1990) 73 O.R.(2d) 545, 70 D.L.R. (4th) 644 (H.C.J.). The Court held that the *Charter* does not protect purely commercial rights, such as the right to maximize profits from property.

[14] L.C. Becker, "Rent Control is Not a Taking" (1989) 54 Brook. L. Rev. 1215 at 1216.

[15] See *Block, supra* note 12 at 460 for a similar view.

[16] On this more general question of when, if at all, there should be compensation for regulatory 'burdens', see J. Quinn & M.J. Trebilcock, "Compensation, Transition Costs and Regulatory Change" (1982) 32 U.T.L.J. 117.

[17] *Supra* note 1 at 750.

[18] In a response to Becker's reply, Epstein argues that taxation is compensated by the government in the services it provides to the taxpayer: R.A. Epstein, "Rent Control Revisited: One Reply to Seven Critics" (1989) 54 Brook. L. Rev. 1281 at 1284. This may be a normative view of what revenue should be devoted to, but is clearly not an accurate description of taxation in America. Foreign aid, for example, does not provide a direct benefit to the taxpayer any more than rent control does to a landlord.

[19] Ontario, *Report of the Commission of Inquiry into Residential Tenancies*, vol. II (Toronto: Queen's Printer for Ontario, 1987) (Commissioner: S. Thom).

In sum, Epstein's analysis is dubious for two reasons: first, it is unclear that rent control constitutes a taking of property; and second, even if it does constitute a taking, it is possible for rent control to be designed so as to fairly compensate landlords for that property so taken.

III. Property and Personhood

Margaret Jane Radin suggests that some forms of property, such as housing, are integral to one's personhood and thus should not be fully commodified.[20] From this she concludes that rent control that keeps rents below market levels, and thus permits a tenant to stay in her or his home, may be justified in order to permit the tenant's personhood to flourish.

Radin bases her argument on some general intuitive notions that she contends a majority of people hold. She states:

> Most of us, I think, feel that a tenant's interest in continuing to live in an apartment that she has made home for some time seems somehow a stronger or more exigent claim than a commercial landlord's interest in maintaining the same scope of freedom of choice regarding lease terms and in maintaining a high profit margin.[21]

Radin also states, however, that this intuition does not typically apply to prospective tenants, as opposed to incumbent tenants. She contends that:

> When we consider people who are tenants elsewhere and wish to become tenants in the rent-controlled community, we are not struck with a similar general intuition of a strong claim.[22]

Thus, she concludes:

> [T]he salient distinction is not (or not only) between noncommercial and commercial interests, or even between use as a home versus other uses. The salient point is rather the strength of one's interest in an *established* home versus other interests....[23]

Radin develops these intuitions into a theory of the difference between personal property and fungible property.[24] Personal property is integral to one's personhood, while fungible property is held merely instrumentally. Put another way, fungible property is fully commodified, while personal property is "at least partially noncommodified."[25] Certain kinds of personal property, that are justifiably bound up with personhood — like housing — she contends are worthy of societal protection from complete commodification. If housing is treated as any other market good, then rising market rents may force a tenant out of his or her home and thereby interfere with the development of her or his personhood. An uprooted tenant loses day-to-day contact with his or her neighbours, friends, local schools, community networks, and so forth, which

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20 *Supra* note 2.
21 *Ibid.* at 359.
22 *Ibid.* at 361.
23 *Ibid.* at 361-62.
24 This builds on a distinction Radin first postulated in an earlier article: M.J. Radin, "Property and Personhood" (1982) 34 Stan. L. Rev. 957.
25 *Supra* note 2 at 362.

interferes with her or his human flourishing. Rent control protects the tenant from these dangers of complete commodification.

A possible rejoinder to this argument is that the government could simply tax everybody and subsidize tenants with these funds, rather than tax landlords specifically through rent control. Radin responds that by specifically restricting the ability of landlords to commodify fully personal property, rent control better protects personhood than a general system of taxation. She states:

> [I]f government must respect equally the personhood of all, it cannot permit forms of fungible property that make full self-development impossible for one class while not being necessary to the development of the holders. If the government has erroneously permitted wrongful fungible property, or wrongful commodification, and acts to correct its error, compensation is not appropriate, for reasons analogous to why it is inappropriate to compensate "expropriated" slaveholders.[26]

Radin concludes that rent control may be justified on this personhood analysis where tenants are poorer, and thus more likely to be economically evicted in the face of market rents. This is particularly so where landlords hold their property strictly for investment purposes. Radin also accepts that efficiency losses created by distortions in the rental housing market resulting from rent control should be considered in deciding whether to implement rent control. She concludes that:

> [O]n balance rent control may be justified, especially if...purely commercial and market factors (especially economic rents to landlords) are such that efficiency losses are relatively low.[27]

Several questions are raised by this analysis. At root, Radin's argument is based on 'general' intuitions about housing that she claims most of us have. For example, economic eviction of an incumbent tenant is more undesirable than the denial of an apartment to a prospective tenant. Other authors' trenchant criticism of this 'intuition' suggests that it may not be as generally held as Radin contends. Epstein states:

> Professor Radin's principle cuts against the very idea of an open society in which there is equal opportunity for advancement and trade for all. The same principle could be used to justify exclusionary zoning, including that which is based on racial or ethnic grounds....And it can, of course, be used to erect powerful barriers against immigration of cheap foreign labor (my grandparents, for example).[28]

If this 'intuition' is rejected, Radin's argument is significantly weakened. If people do not generally believe that losing an apartment is more undesirable than being denied an apartment, then people do not place the same emphasis on housing and personhood as Radin does, and the strength of the personhood argument for rent control is diminished.

Even accepting Radin's submission about our intuitions does not resolve the question of the importance of personhood. Rather than personhood, an intuition about the undesirability of economic eviction as opposed to denying a prospective tenant an apartment may be based on the perceived difference between losses incurred and losses

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[26] *Ibid.* at 367.

[27] *Ibid.* at 371.

[28] *Supra* note 1 at 771-72.

foregone. High rent leaves both prospective and incumbent tenants without housing (by assumption), but the incumbent tenant has lost a home, while the prospective tenant has lost an opportunity to obtain a home. While theoretical economics suggests that both are equally disadvantaged (neither has a home), behavioural studies suggest that people view losing something they once had as more undesirable than losing an opportunity. This 'endowment effect' (people's bias to retain their endowments rather than trade) has been consistently observed in experiments. As Knetsch observes:

> Virtually all controlled evaluation tests, as well as the commonplace reactions of people to real choices, point to large and persistent differences between the valuation of losses and foregone gains.[29]

For example, one study was conducted whereby each of one group of participants was given a chocolate bar, while each of a different group was given a mug.[30] Each participant was then given a chance to trade the mug for the chocolate bar or vice-versa. If losses and foregone gains are viewed equally by the participants, roughly the same ratio of chocolate bars to mugs should exist after trading in either group. Instead, about 90 per cent of each group preferred their endowment of a chocolate bar or mug to the other good. Thus the value placed on the good depended on whether it was initially possessed or not. This endowment effect has been confirmed in numerous other studies.[31]

Radin's intuition may thus be based on a common reaction that has little to do with personhood. While in the experiment described above people valued more highly either the mug or the chocolate bar depending on initial endowments, it is unlikely that either good significantly contributed to the individual's personhood. To the extent that Radin's reasoning may be characterized by the statement, "eviction of an incumbent tenant is worse than denying someone an apartment, therefore personhood is important," it is flawed. A more accurate statement would be: "eviction of an incumbent tenant is worse than denying someone an apartment, therefore either personhood is important, or the endowment effect is present, or both."

Accepting Radin's submission that housing is integrally related to personhood leads to a further troubling aspect of her analysis. While housing may be bound up with personhood, this should not be the only factor in concluding that it is worthy of state protection. Other items, such as stamps for the stamp collector, or money for the miser, may also be bound up with personhood, yet few would conclude that state intervention is justified to protect those aspects of their personhood. Radin responds that not all property that contributes to personhood is worthy of protection, only property that justifiably contributes to personhood. She states, for example, that money for the capitalist should not be protected:

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[29] D. Cohen & J.L. Knetsch, "Judicial Choice and Disparities Between Measures of Economic Values" (1992) 30 Osgoode Hall L.J. 737 at 743.

[30] J.L. Knetsch, "The Endowment Effect and Evidence of Nonreversible Indifference Curves" (1989) 79 *The American Economic Review* 1277.

[31] See *e.g.* J.L. Knetsch & J.A. Sinden, "Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value" (1984) 99 *Quarterly Journal of Economics* 507; D. Kahneman, J.L. Knetsch & R.H. Thaler, "Experimental Test of the Endowment Effect and the Coase Theorem" (1990) 98 *Journal of Political Economy* 1325; R.C. Bishop & T.A. Heberlein, "Measuring Values of Extramarket Goods: Are Indirect Measures Biased?" (1979) 61 *American Journal of Agricultural Economics* 926.

> The empire of the "compleat capitalist"...might contribute to her continuity and to her own sense of fulfillment, but it would not contribute to her being a well-developed person, for the "compleat capitalist" is not well-developed; she has embraced an inferior concept of human flourishing.[32]

The obvious danger with such an approach is that it may rely on an arbitrary distinction between what is and what is not an acceptable 'concept of human flourishing.' Trebilcock states that Radin's suggestion "seems inevitably to lead to...arbitrary and conclusory judgments on a case-by-case basis."[33] As Brennan points out, Radin's justification for rent control risks descending to the following statement: "[T]enure in an apartment should be protected because it is a justifiably good thing to protect."[34]

Drawing a policy conclusion from Radin's analysis is also problematic. There is no apparent reason under her theory for a landlord to receive any rent once a tenant has moved into an apartment and it has become part of her personhood. Any rent paid by the tenant is at least a hindrance for the tenant seeking full development of his or her personhood, and any rent received by the landlord is a reward for her or his commodification of housing. Any effects this has on the supply of new rental apartments is unimportant, if not irrelevant, as new apartments are not integral to the personhood of an incumbent tenant. Furthermore, restrictive conversion laws (which are consistent with the personhood argument no matter what the rent) could prevent the possible withdrawal of housing from the rental market. While this zero rent regime is compatible with a completely non-utilitarian version of Radin's argument, the clearly significant efficiency losses it would imply in the form of a reduced supply of housing, and the unfairness to the landlords it entails, would leave it unappealing to most people. Indeed, in assessing a situation suitable for rent control, Radin calls for an examination of the efficiency losses from imposing rent control in a particular area. As noted above, she states that an area is more suitable for rent control if the efficiency losses resulting from its imposition are relatively small. She also contends:

> As with all practical moral decisions, there can still be undecided hard cases, for example if efficiency losses are very high, tenants are a poor community that is deeply self-invested, and many landlords are noncommercial while not feeling community solidarity with their tenants.[35]

Rather than a strict autonomy theory of rent control, Radin's analysis appears to implicitly call for a utilitarian approach (why else is efficiency at all relevant?) with an emphasis on the importance of property and personhood; a consideration of personhood alone is inadequate. This is consistent with the justification for moderate rent control offered below.

IV. THE WELFARE APPROACH TO RENT CONTROL

The most frequently advanced rationale for rent control is to focus on its welfare-enhancing or reducing features. While there is rarely a consensus among economists on

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[32] *Supra* note 2 at 365.

[33] M. Trebilcock, *The Limits of Freedom of Contract* (Cambridge, Mass.: Harvard University Press, 1993) at 26.

[34] T.J. Brennan, "Rights, Market Failure, and Rent Control: A Comment on Radin" (1988) 17 *Philosophy & Public Affairs* 66 at 68.

[35] *Supra* note 2 at 371.

any issue, rent control appears to be an exception to this rule. Economists, as Epstein notes, are "well nigh unanimous in their condemnation of rent control statutes."[36] In introducing a book of essays on the subject, Block states that "although the reader will not find any support for rent control in the present volume, the essays do reflect the widest consensus within the economics profession."[37] There are many reasons for this consensus. This section will first outline what are considered to be the short and long-run drawbacks of rent control. The possible welfare benefits of rent control will then be discussed.

A. *Welfare Reducing Qualities of Rent Control*

One short-run effect of rent control that suppresses rents below their equilibrium market price is to increase the attractiveness of rental housing relative to other goods. This creates an inefficient allocation of rental space. Tenants who succeed in obtaining a rental unit will consume too much housing relative to other goods, such as food, since the price ratio between the goods is distorted. If a free market prevailed, relative prices would indicate the relative demand for the products, goods would be allocated efficiently according to demand, and aggregate social welfare would be maximized. As Stanbury and Todd note:

> [B]y holding price down, the number of households seeking rental accommodation will increase. Of course, the incentive of lower prices is dampened by the lack of availability.[38]

Rent control causing artificially low prices will thus create allocative inefficiency by causing households who obtain housing to overconsume housing (for example, taking an apartment that is larger than would be chosen if rent were set by the market), while frustrating those who are unable to obtain rental housing because of increased demand.

Rent control may also distort the mobility decisions of tenants. If a person is living in a rent-controlled apartment with rents below market rates, he or she will be reluctant to move and possibly lose this economic advantage. This will in turn distort other markets, such as the labour market. Hayek described this phenomenon in the Austrian market:

> A manufacturer of my acquaintance, with a factory in a small town some five hours from Vienna and an office in Vienna itself, went to the labor exchange in Vienna to ask for an electrical fitter for his provincial factory. Twenty or so fitters, some of whom had been out of work for a long time, applied for the vacancy, but every one of them withdrew rather than give up a protected tenancy in Vienna for unprotected works accommodation. Weeks later the industrialist had still not found his fitter.[39]

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[36] *Supra* note 1 at 759-60, referring to B.S. Frey, W.W. Pommerehne, F. Schneider & G. Gilbert, "Consensus and Dissension Among Economists: an Empirical Inquiry" (1984) 74 *The American Economic Review* 986.

[37] W. Block & E. Olsen, eds., *Rent Control: Myths and Realities* (Vancouver: Fraser Institute, 1981) at xv.

[38] W. Stanbury & J. Todd, *Rent Regulation: The Ontario Experience* (Vancouver: Canadian Real Estate Research Bureau, 1990) at 100.

[39] F. Hayek, "The Repercussions of Rent Restrictions" in Block & Olsen, eds., *supra* note 37, 171 at 178.

Note that this problem would be exacerbated by a housing shortage, which, as will be discussed below, may be engendered by rent control in the long-run, since tenants will be particularly reluctant to leave an apartment if finding another would be difficult.

Another common objection to rent control is that it is said to reduce the quality of housing. This argument is often posed in a problematic way. It is suggested that with rent control, landlords will earn less revenue from their properties and will therefore be reluctant to spend on maintenance in order to earn a reasonable return. As Olsen and Walker state:

> Faced with a rate of return on investment that is too small, many landlords recoup their losses on a current basis by allowing the physical stock of houses to depreciate at a faster rate. That is, regular maintenance and repair is neglected.[40]

This version of the argument is unconvincing. Landlords are presumably profit maximizers. Thus, for a given revenue, they will minimize costs regardless of whether they are earning a 'reasonable' return.

The argument is more convincing if posed slightly differently. If rents are controlled, additional expenditure on maintenance will not increase revenue. If market prices govern, however, landlords will be forced to maintain properties or forego rent. They will spend on maintenance until the marginal cost of maintenance equals the marginal revenue from such expenditure. In a competitive market, this results in optimal maintenance.

A further disadvantage of rent control that succeeds in keeping rent below market levels is its effects on wasteful litigation. If unregulated alternatives to renting out an apartment exist, landlords face an increased incentive to remove tenants in order to put the property to more profitable uses. As Epstein states:

> Removal for cause typically allows the landlord to recapture a substantial portion of the unit's value, for example, by removing the unit from controls by "rehabbing" it, or by selling it as a condominium. Now the battle over for cause dismissal is a high stakes affair. Small deviations from the leasehold provisions therefore are no longer small items for the parties to resolve by informal adjustments.[41]

This is also true if rent control only governs increases in rent, rather than the initial rent. If rent control keeps rent below market levels, there will be an increase in litigation by landlords seeking to evict incumbent tenants with low, controlled rents so that new, market rate tenants may be accommodated.

While these short-run distortions resulting from rent control where rent is kept below market levels are a concern, perhaps the most frequently cited vice of this form of rent control is its effect on the longer-run supply of rental housing. If rents are kept artificially low, there is a detrimental effect on the supply of new rental housing: current landlords may withdraw their units from the market and put them to alternative uses, and prospective landlords will be reluctant to build in order to reap inadequate returns. Thus if rent control is imposed to respond to a housing shortage which has caused rents to rise dramatically, it will only exacerbate the shortage by decreasing the stock of current and future housing. Friedman and Stigler describe the situations following the San Francisco earthquake and subsequent fires in 1906 that destroyed about half of the city's housing

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40 E.O. Olsen & M.Walker, "Alternatives" in Block & Olsen, eds., *supra* note 37, 267 at 273.
41 *Supra* note 1 at 765.

stock, and the housing shortage in San Francisco following the Second World War.[42] In 1906 rent control was not imposed and, despite the severe decline in available housing, the *San Francisco Chronicle* after the disaster listed 64 offers for rental housing as opposed to only five advertisements for housing wanted.[43] On the other hand, in the 1946 shortage, which, according to Friedman and Stigler, was only about a quarter as severe as the 1906 shortage,[44] rent control was imposed and in the first five days of the year the *San Francisco Chronicle* listed only four offers of accommodation, while 30 advertizements per day sought rental housing.[45]

It is often asserted that since under many rent control statutes new buildings are not subject to rent control, this supply shortage argument is inapplicable. As Mandel observes:

> [T]he construction of new apartments is determined by their rent, which under [many] existing rent control laws is unregulated. This suggests that these laws will *not* depress the supply of new apartments.[46]

This claim may be strengthened by the analysis of Fallis and Smith of uncontrolled rents in a market where some rents are controlled.[47] They show that if demand rises for apartments, and incumbent tenants in rent controlled housing do not leave their protected apartments, prices for new rental apartments will rise more than they would if no rent controls were imposed. Essentially, as Mandel puts it, "new tenants are chasing a smaller pool of available apartments."[48] Thus rent control may actually result in increased incentive for builders to add to the rental housing stock.

The difficulty with this claim, however, is that rent control that keeps rents below market rates may be seen as opportunistic behaviour by a government exploiting a sunk investment in housing, and the threat of rent control *ex post* is likely greater in a jurisdiction where the government has imposed rent control than where it has not. The same reason for imposing rent control initially may persuade the government to extend it to new housing later. This danger is illustrated by the following comment by Radin:

> The exemption for new buildings may be seen primarily as a method of offsetting the decrease in supply of rental housing that simple price theory predicts. There is no personhood interest to protect in housing that has never been occupied. (Serious problems arise if rent control goes on for a long time and a twenty-year-old building is exempt because it succeeded rent control. *Jurisdictions with long-term rent control must adjust such problems from time to time*) [Emphasis added].[49]

Developers may thus be reluctant to build even if new buildings are exempt from rent control given the risk of future 'adjustments' to include new buildings in the regime. This

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42 M. Friedman & G. Stigler, "Roofs or Ceilings? The Current Housing Problem" in Block & Olsen, eds., *supra* note 37, 87.

43 *Ibid.* at 88.

44 *Ibid.* at 88-89.

45 *Ibid.* at 89.

46 M.J. Mandel, "Does Rent Control Hurt Tenants?: A Reply to Epstein" (1989) 54 Brook. L. Rev. 1267 at 1268.

47 G. Fallis & L.B. Smith, "Uncontrolled Prices in a Controlled Market: The Case of Rent Controls" (1984) 74 *The American Economic Review* 193.

48 *Supra* note 46 at 1269-70.

49 *Supra* note 2 at 372-73.

suspicion was confirmed in Ontario, where 'temporary' rent controls initially imposed in 1975 exempted new housing, but in 1986 rent control was extended to all rental housing in Ontario. Even if rent control does not apply to new housing, the threat of its imposition *ex post* is likely to have a greater 'chilling' effect on construction in a jurisdiction where rent control is at present imposed.

B. *Welfare Enhancing Qualities of Rent Control*

1. *Redistribution*

Theoretical economic arguments in favour of rent control are relatively scarce. One welfare argument is that rent control is valuable as a redistributive tool. If the social welfare function is such that the equalization of wealth across people is to some extent desirable, and if landlords are wealthier than tenants, then rent control that keeps rent below market levels acts to redistribute wealth in a socially desirable way.

There are significant problems with this analysis. First, it is entirely unclear why wealthy landlords should pay and poor tenants should benefit, rather than the wealthy and poor classes as a whole. Rent control arbitrarily singles out the housing market as the appropriate forum for redistribution. Kronman suggests, however, that many forms of taxation for redistributive purposes also single out sub-sets of the community.[50] The regulation of private contracts, such as rent control, is therefore not inconsistent with other discriminatory forms of government intervention. Furthermore, relative to the costs of collecting and distributing tax revenue, contract regulation (such as rent control) redistributes in one step and may thus save resources.

As Trebilcock contends, Kronman's argument is largely unpersuasive. Trebilcock states:

> [C]ontract regulation, almost by definition, entails imposing disproportionate distributive burdens on some sub-set of society on the relatively fortuitous basis that they happen to be involved in exchange relationships with other members of society who engage our distributive concerns. This seems an ethically perverse basis on which to single them out to bear this burden.[51]

Furthermore, to the extent that contract regulation, such as rent control, creates undesirable distortions in the market, such as a reduced supply of housing, those intended to benefit, the poor, may be harmed. Thus rent control (that keeps rent below market levels) is an arbitrary choice as a vehicle for redistribution, and may do more harm than good to poor people by reducing the housing stock. This conclusion is supported by evidence of the Ontario experience with rent control.

First, Stanbury concludes that, "Whatever the intent of Ontario's system of rent regulation, it is apparent that the supply of rental housing has been reduced."[52] Second, there is evidence that the middle class, rather than the poor, disproportionately benefit from rent control. For example, Stanbury and Vertinsky found that the 56 per cent of households in Ontario with incomes above $15,000 in 1981 received 84 per cent of the

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[50] A.T. Kronman, "Contract Law and Distributive Justice" (1980) 89 Yale L.J. 472.
[51] *Supra* note 33 at 100.
[52] *Supra* note 38 at 96.

pecuniary benefits of lower rent (the average income at the time was $17,600).[53] Aside from the questionable ethics of singling out tenants as beneficiaries, rather than the poor generally, there is thus also evidence that tenants include people that most would not consider worthy of redistributive concern.

Second, not only is rent control an inappropriate instrument for redistribution, it is also an inappropriate method to ensure the affordability of housing. Many contend that housing is a special product that should be made affordable for all; rent control may be necessary to ensure that all can afford housing. Dobkin states that the purpose of rent control is, "to protect the millions of people who through no fault of their own simply cannot compete in an overheated rental market."[54] The statistics offered by Stanbury and Vertinsky suggest that rent control is a rather blunt instrument to assist the poor to find housing. Rent control in Ontario appears to have subsidized housing largely for the benefit of the middle class, while the shortages rent control creates or exacerbates will also hurt the poor. If affordability of housing is perceived to be a problem, methods other than rent control, such as publicly provided housing or housing subsidies for the poor, should be employed to address it. Indeed, this was the conclusion of the Ontario Inquiry mentioned above.[55]

2. *Imperfect Competition*

Other arguments suggest that rent control may have positive efficiency effects, rather than redistributive effects. One such argument rests on imperfect competition in housing markets. If landlords have market power, then rents will be higher than the optimal market clearing price. Consequently, some prospective renters will be priced out of the market, and a deadweight loss to social welfare results. Rent control may correct this welfare-reducing distortion by forcing rents below the supra-competitive rents landlords would otherwise charge. This, however, is unlikely to carry much empirical significance, given the large number of landlords in most urban settings. As Thom states:

> There are too many different companies and individuals with the financial resources and expertise to develop rental housing for a credible argument to be made that they collaborate to keep rental housing in short supply and hence rents and returns at excessively high levels.[56]

3. *Smoothing Price Paths*

A different argument suggests that rent control might be an appropriate response to volatile price changes in rental housing. Ordinarily a shift in demand for a product results in an increase in the price and the quantity consumed of a product. In the housing market, however, the short-run stock of housing is virtually fixed; an increased quantity of housing will take time to develop and build. Any positive shift in demand will therefore only have a price effect in the short-run. Thus in the absence of rent control, a positive

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[53] Ontario, Commission of Inquiry into Residential Tenancies, *Rent Regulation: Design Characteristics and Effects* (Research Study No. 18) by W.T. Stanbury & I.B. Vertinsky (Toronto: Commission of Inquiry into Residential Tenancies, 1986) at 6-112.

[54] S. Dobkin, "Confiscating Reality: The Illusion of Controls in the Big Apple" (1989) 54 Brook. L. Rev. 1249 at 1259.

[55] *Supra* note 19.

[56] *Ibid.* at 143-44.

shift in demand will cause a large increase in rents which will fall gradually as the supply of housing increases. Once the new equilibrium is reached, rents will be higher than initial rents (reflecting the greater demand for housing), but below rents immediately after the shift in demand, and the supply of housing will be higher.[57] This initial volatility after a demand shift allows the landlord to charge very high rents. Cirace contends that:

> [M]arket adjustments that result in long-run equilibrium may take a very long time to occur in the housing market, and such an unregulated market may result in intermediate rent increases that can only be realistically described as extortionate.[58]

These 'extortionate' rents could entail various social costs that rent control may address. For example, households with liquidity constraints may be forced to move in the short-run when prices leap, but would not have needed to move if prices moved gradually to their new equilibrium level. As Fallis states:

> If during the market adjustment process, tenants moved in and out of units as the relative price rose and fell and resources moved in and out of the housing sector, then it might be argued that a smooth price path would be more efficient, since some of the resources used to move tenants in and out and to move other resources in and out could be saved.[59]

Thus a jump in price results in unnecessary moving costs. Allowing rent to rise gradually through rent control may therefore be more efficient than allowing spikes in the price of rental housing.

4. *Theory of the 'Second Best'*

A further rationale for the imposition of rent control is the theory of the 'second best.' That is, rent control may help compensate for the existence of other government policies that are creating distortions elsewhere in the economy. The 'first best' solution is to eliminate these other distortionary policies, but if this is politically impossible, imposing rent control may correct this distortion. For example, restrictive zoning laws may drive up the price of housing. Rent control may divert a more efficient amount of resources into non-housing sectors by keeping rents low, rather than allowing rents of a housing stock fixed by zoning laws to increase. The clear response to this justification for rent control is that removing the other distortions is preferable to imposing a further distortion. Nonetheless, if there is strong political opposition to the removal of these other distortions, imposing rent control may be the 'second best' policy. As Baar contends, "rent control may constitute an adjustment within a heavily regulated system."[60]

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[57] This makes the usual assumption that the demand curve for housing slopes down (lower prices imply greater quantity demanded) and the supply curve for housing slopes up (higher prices imply greater quantity supplied). When the demand curve shifts, the entire effect of this shift will be to raise price in the short-run as quantity is fixed. As the housing supply increases, this price will come down.

[58] J. Cirace, "Housing Market Instability and Rent Stabilization" (1989) 54 Brook. L. Rev. 1275 at 1277.

[59] Ontario, Commission of Inquiry into Residential Tenancies, *Possible Rationales for Rent Regulation* (Research Study No. 5) by G. Fallis (Toronto: Commission of Inquiry into Residential Tenancies, 1984) at 39. Fallis is sceptical of this argument given the scarcity of empirical evidence supporting it.

[60] K.K. Barr, "Would the Abolition of Rent Controls Restore a Free Market?" (1989) 54 Brook. L. Rev. 1231 at 1235.

5. *Security of Tenure*

Rent control may protect tenants from 'economic eviction,' whereby landlords evade security of tenure laws by raising rents to levels that tenants are unable to pay. As Weinrib and Makuch point out:

> It is clear that security of tenure and rent regulation are (at least in a limited way) inseparable because security of tenure would not be possible without at least some rent regulation; otherwise rents could simply be raised in order to bring about the *de facto* termination of a tenancy.[61]

If security of tenure is deemed important to social welfare for its own sake, which may be reflected in the existence of security of tenure laws in many jurisdictions, rent control may provide a welfare benefit by protecting tenants from economic eviction.

The protection of security of tenure resulting from rent control may also have an efficiency effect. Arnott describes a model of the housing market that illustrates this.[62] There are two types of tenants, good and bad, but landlords cannot identify the type *ex ante*. After one period, the bad tenants are identified. In the absence of rent regulation, landlords will economically evict bad tenants after one period, thereby imposing an externality on other landlords from whom the bad tenants rent in the next period. As Arnott states, "there is a bad-tenant turnover externality--a beggar-thy-neighbor policy with respect to bad tenants."[63] Rent control prevents landlords from idiosyncratically raising rents to bad tenants (thus unnecessarily increasing tenant turnover). This has the economically beneficial effect of eliminating the bad-tenant externality. Thus, protecting security of tenure may have efficiency effects.

6. Ex Post *Opportunism*

This section will focus on the existence of specific sunk costs and the potential for *ex post* opportunism that they present, particularly to landlords.

Wherever one party to a transaction must incur greater specific sunk costs than the other party, there is a danger that the other party will exploit the commitment these costs imply, especially at contract renewal time.[64] For example, if an electric company builds a plant beside a coal mine (which may sell to alternative sources at the market price), the mine is in a position to exploit the company. Given the enormous sunk costs of a plant, and the costs implied by its idleness, the mine may sharply increase the price of coal, which the electric company will pay given the cost of not being supplied with coal. *Ex ante* the electric company will expect this, and will therefore be reluctant to build the plant. This is known as the hold-up problem.

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[61] Ontario, Commission of Inquiry into Residential Tenancies, *Security of Tenure* (Research Study No. 11) by S.M. Makuch & A. Weinrib (Toronto: Commission of Inquiry into Residential Tenancies, 1985) at 1.

[62] R. Arnott, "Time for Revisionism on Rent Control?" (1995) 9 *The Journal of Economic Perspectives* 99 at 107.

[63] *Ibid.*

[64] For a survey of the literature on this problem, see K. Crocker & S. Masten, "Regulation and Administered Contracts Revisited: Lessons from Transaction-Cost Economics for Public Utility Regulation" (on file with author). In discussing the potential for *ex post* opportunism in contract modifications, see V. Aivazian, M.J. Trebilcock, & M. Penny, "The Law of Contract Modifications: The Uncertain Quest for a Bench-Mark of Enforceability" (1984) 22 Osgoode Hall L.J. 173.

Ordinarily this problem is overcome by either long-term contracting, or by vertical integration.[65] If the price of coal is set in a long-term contract (or a formula for determining the price of coal is set), the electric company will be protected from *ex post* opportunism and will be therefore willing to build the plant. Alternatively, the electric company could vertically integrate by purchasing the mine. Vertical integration will also protect the company from *ex post* opportunism, and the plant will be built.

Specific sunk costs in the rental market may lead to hold-up problems. For a tenant to move from one apartment to another, he or she must incur significant pecuniary transaction costs. The tenant must locate a different unit within an appropriate price range with relevant locational and other characteristics, and incur the physical cost of moving. If the tenant does not locate an apartment quickly, he or she faces the additional costs of being without an apartment for a period (which costs at least the rental rate previously paid, since the apartment must have been worth at least the rental rate to the tenant, or he or she would not have rented). However, if a tenant moves the landlord must also incur some pecuniary transaction costs: advertising and the time costs of showing prospective tenants the unit. Furthermore, if the landlord does not quickly locate a tenant, he or she incurs the cost of being tenantless.

The tenant, however, faces costs that the landlord avoids: the non-pecuniary costs of moving from one's home and community. As Radin argues, an apartment and its surrounding community may be an integral part of a person's life, and the upheaval implied by moving may be very significant. This is illustrated by the results of a survey conducted by Knetsch, Kahneman and McNeill.[66] They found that up to 20 per cent of tenants, with average monthly rents of $443, would refuse to move from their apartments even if offered a payment of $10,000 on top of full compensation for the pecuniary costs of moving.[67] They conclude that "tenants may experience a fairly substantial loss in welfare if they have to move involuntarily."[68]

Various commentators have suggested that the landlord-tenant relationship is like a bilateral monopoly due to the symmetry of costs facing the parties if a tenant moves. Stanbury, for example, asserts that "the costs attendant to a tenant moving out are largely reciprocal" between the landlord and tenant.[69] While it is questionable whether the pecuniary costs of changing units are symmetrical between the landlord and tenant (for example, an apartment building may employ a full-time superintendent, so the marginal costs of showing prospective tenants an apartment may be very low), the non-pecuniary costs are clearly greater for the tenant. The bilateral monopoly model of landlord-tenant relations is not convincing. As Yee states:

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[65] See *e.g.* O.E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations" (1979) 22 *Journal of Law & Economics* 233.

[66] Ontario, Commission of Inquiry into Residential Tenancies, *Residential Tenancies: Losses, Fairness and Regulations* (Research Study No. 14) by J.L. Knetsch, D. Kahneman & P. McNeill (Toronto: Commission of Inquiry into Residential Tenancies, 1984).

[67] *Ibid.* at 12-13.

[68] *Ibid.* at 16.

[69] Ontario, Commission of Inquiry into Residential Tenancies, *The Normative Bases of Rent Regulation* (Research Study No. 15) by W.T. Stanbury (Toronto: Commission of Inquiry into Residential Tenancies, 1985) at 4-25.

> [I]t is clear that the tenant suffers far more loss in having to find and move to a new home than the landlord suffers in having to find a new tenant. This puts the landlord in a much stronger bargaining position with existing tenants.[70]

While Yee focuses on the value of protecting security of tenure as a result of these moving costs,[71] the asymmetry of specific sunk costs in the landlord-tenant relationship also creates, as in the coal example, the potential for *ex post* opportunism. Once the tenant has settled into his or her apartment and the community, the landlord may exploit this investment by raising the rental rate above the market rate, and the tenant will be willing to pay it rather than incur the costs of moving. Thus there is a hold-up problem. Some tenants will anticipate this *ex post* opportunism, and two socially harmful effects will follow. First, some tenants will leave the rental market altogether. There will be a subset of tenants that would be willing to rent at the market price, but the spectre of *ex post* opportunism induces them to purchase a residence rather than incur the cost of being held-up. Second, other tenants will remain in the market, but will underconsume housing (for example, by 'doubling up') relative to their consumption if the hold-up problem were eliminated. For both these reasons, rental housing will be underconsumed. This constriction of the rental market results in a social deadweight loss.

As discussed above, long-term contracting or vertical integration is ordinarily employed to overcome this problem. If a tenant is concerned about opportunism on the part of the landlord, she or he may enter a long-term lease to protect himself or herself from high rent increases in the future. Alternatively, she or he could vertically integrate and purchase a home, rather than lease it. For many tenants, however, these options are unsatisfactory. Despite the fact that there is a bias in the Canadian tax system toward owning a residence (for example, the principal residence is free of capital gains tax), there is a fully developed rental market with relatively short-term leases. This renting may result from liquidity constraints: the poor cannot afford the down payment necessary to obtain a mortgage on a home. A different reason, however, is that there is a significant portion of the population facing uncertainty in their lives. A young couple with a small child, for example, may be reluctant to enter a long-term lease for a two-bedroom apartment, given the possible arrival of more children. For these people, a long-term contract[72] or home purchase is inappropriate, but this does not imply that the hold-up problem is lessened. They still will develop a psychological attachment to their apartment (resulting from local schools/day-care, friends, job locations, and so forth) that has the potential for exploitation by the landlord. However, the possibility of major upheaval (that would be significant enough for them to incur the moving costs), leaves long-term contracting or purchasing a residence inappropriate. Thus, the hold-up problem will not be fully addressed by long-term contracting, and a sub-optimal housing market will result.

A further reason why long-term contracts, including option arrangements (whereby the lease may be renewed at a pre-set price), are rarely observed in the housing market[73] may be the adverse selection problem described above in discussing security of tenure. There is a chance that a prospective tenant is 'bad.' If a long-term lease is entered into by the landlord, or a lease with a unilateral renewal clause for the tenant is entered into,

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[70] G. Yee, "Rationales for Tenant Protection and Security of Tenure" (1989) 5 J.L. & Social Pol'y 35 at 41.

[71] *Ibid.*

[72] Renewal options will be discussed below.

he or she may lose the ability to economically evict a 'bad' tenant. As noted above, this may be privately optimal, but socially detrimental due to the externality to other landlords. For this reason, landlords may hesitate to offer option clauses or long-term contracts in unregulated markets.

Finally, there are significant transaction costs in entering into a long-term contract or a contract with perpetual renewal clauses. The bargaining costs of determining a fair price into the future, and the potential opportunity costs to either the tenant or landlord if this price schedule does not reflect future market conditions, may be a further reason why long-term contracts are not observed in the rental market.

To illustrate the effects of the hold-up problem, consider the following model of the rental market. All renters face significant transactions costs in moving, and all are reluctant to enter long-term contracts. The housing market is assumed to be in equilibrium, so that an optimal market rent exists. In this case, if the market rent is initially charged to tenants, there will be a hold-up problem from the possible *ex post* exploitation of renters, and a sub-optimal rental market will develop as prospective renters drop out of the market.

Brennan suggests that discounts may be offered in the first period of rental to compensate for inevitable exploitation later. He states:

> Current short-term rental agreements may well embody initial discounts to compensate potential tenants for the costs of subsequent expected opportunistic behaviour.[74]

That is, the first period rent could be discounted by the present value of the future amount that landlords will charge in exploiting a tenant's specific investment in an apartment. However, these discounts create further distortions in the market. By lowering first period rents relative to the market rent, and allowing subsequent rents to rise above market levels due to exploitation of specific investment, discounts distort relative prices and create a bias towards moving out of an apartment to a different apartment with a first period discount; the length of tenure is pushed down. This is analogous to the difficulty that Klein points out in the photocopier market if after-sales service is tied to the purchase of a machine.[75] If discounts are offered for the machine itself in order to compensate for future opportunistic behaviour in the price of service, customers will underconsume services and overconsume machines.

A further problem with discounts is that they may not be feasible if the rental market model is changed from the above model where all renters face significant switching costs to a more realistic model where only a subset of the population faces switching costs. Assume now that there are some people who grow attached to their homes (Radinites), while others are relatively indifferent about where they live (Epsteinians). It is impossible to distinguish types of people *ex ante*. If landlords discount first period rent, Epsteinians will enjoy low rent for a period, then switch housing to enjoy low rent in a different apartment's first period. Epsteinians will thus drive up the rent in the first period. Given the possibility of renting to a Radinite, however, landlords may still attempt to exploit a rental premium *ex post*: if the tenant is an Epsteinian, the landlord must find a new tenant, but if the tenant is a Radinite, she or he may reap supra-competitive profit. It may be profit-maximizing (depending on the relative proportion of Radinites to Epsteinians,

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73 See Arnott, *supra* note 62.

74 *Supra* note 34 at 76.

75 B. Klein, "Market Power in Antitrust: Economic Analysis after *Kodak*" (on file with author).

and the size of the Radinites' transactions costs) to charge this premium *ex post*. This will lead to the reoccurrence of the hold-up problem for Radinites, who will be reluctant to rent, even though they would be willing to do so at the market rent.

In sum, the hold-up problem resulting from asymmetric transaction costs between landlords and tenants will result in the constriction of the rental market, which imposes a deadweight loss on society. This problem will not be addressed by long-term contracts or home purchases, as many renters rent to avoid long-term commitment to a residence given the possibility of future changes in their lives. Furthermore, landlords may be reluctant to offer long-term contracts given the possibility of 'bad' tenants, and the transaction costs of negotiating such a contract may deter both tenants and landlords. As a result of the hold-up problem, some tenants will drop out of the rental market rather than face the costs of *ex post* opportunism by the landlord, and others will continue to rent, but will underconsume housing. Furthermore, discounts in the first period may not be feasible, and even if feasible, they will create distortions of their own (the length of tenure will be biased downwards).

V. THE PROPOSED RENT CONTROL REGIME

Rent control, if properly designed, may address some of the problems with markets where rents are unregulated. Consider the following rent control regime. The landlord is unconstrained in the initial rent charged to a tenant. To address *ex post* opportunism, maximum future rent increases are decided by a rent control authority. In this manner, rent control acts as a substitute for long-term contracting. Unlike most if not all of currently observed rent control regimes, however, this increase need not be below the change in an apartment's market value. The concern is to ensure that rents are not raised above their market value, thus exploiting specific tenant investments. An index of housing market prices could be used to set this price increase. Rather than attempting to determine such an index indirectly, perhaps by relying on the consumer price index alone, this regime permits a more direct inference of the level of rents in the market. Since initial rents are unconstrained, and since there will always be turnover of apartments, the rental authority could create an index of the housing market by monitoring the change in initial rents being charged from year to year. This mechanism will be discussed further below.

A. *The Proposed Regime from a Welfare Perspective*

1. *Benefits*

This regime has many advantages over the unregulated market, without some of the disadvantages usually associated with rent control.

First, by acting as a proxy for long-term contracting, without the rigidities of long-term contracts or the individual transactions costs of bargaining for such contracts, it eliminates *ex post* opportunism on the part of landlords in setting rent increases. The market will not constrict as it would absent such regulation.

Second, it allows the smoothing of rental prices in the face of a shift in demand. If the rental authority discovers a sharp increase in the rise of new rental rates, it can infer a demand shift. The harm of such shifts is that they may create unnecessary upheaval until the supply of housing increases and a new equilibrium is reached. The rental authority, which is knowledgable about the extent of the demand shift from its monitoring of newly rented apartments, could allow rents to rise more slowly than the market would otherwise imply. This may be efficient by cutting down on unnecessary moving after rents leap following the initial shift in demand. Protecting new renters from higher rents is not necessary from an efficiency standpoint (and redistribution, as concluded above, should not be the purpose of rent control) since they will not incur unnecessary transaction costs from moving. The rental authority may smooth out rental increases, thus allowing the market to reach equilibrium on a smoother, more efficient path.

Third, rent control of this nature protects tenants from 'economic eviction', whereby landlords raise rents to levels that tenants are unable to pay. This has two potentially beneficial effects. First, if security of tenure is itself valuable to social welfare, then preventing economic eviction is desirable from a utilitarian perspective. Second, this regime removes the externality that a landlord imposes on other landlords if she or he economically evicts a 'bad' tenant. This may be efficiency enhancing.

While the regime has these advantages, it avoids some of the disadvantages of other forms of rent control. First, by allowing landlords to charge the market price (but only the market price), distortions in relative prices between housing and other goods will not occur. In the short-run, housing will not be overconsumed, nor will tenant mobility be affected by below market rents. In the long-run, supply will be optimal as new landlords will obtain the full market value for their investment.

The regime also overcomes the credibility problem inherent in rent control regimes that set prices below market levels. If a government acts opportunistically and legislates low rents on old buildings, it will have credibility problems in attempting to convince developers, in order to induce supply, that it will not do so again. Under this regime, however, rents are allowed to reach their market levels (but no higher), which is not *ex post* opportunism by governments exploiting landlords' specific sunk costs, but rather a proxy for long-term contracting. Government credibility is preserved.

Note also that the signal to developers to build implied by rising rents is not lost in this regime. The Commission of Inquiry into Residential Tenancies in Ontario concluded that "fair market" rent control would be appropriate.[76] Under this regime, "[t]he fair market rent level is defined to be the rent level that would enable investors in rental housing to earn, on average, a return on their investment that equals the return on alternative investments involving comparable financial risk."[77] Thus, under the Commission's proposed regime, the rent levels are set according to evidence of the return on comparable investments. However, the signalling function of rising rents is at least muted, if not eliminated. Only to the extent that an increase in rents is reflected in an increase in the return on "alternative investments involving comparable financial risk" will the proper signal be provided to developers; idiosyncratic changes in the housing market will not be signalled. With the proposed regime discussed above, however, increases in initial rents will signal to the rental authority that higher rent is appropriate, higher rent increases will be allowed, and the proper signal will be sent to developers to begin building.[78]

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76 *Supra* note 19.

77 Stanbury & Todd, *supra* note 38 at 134.

78 Note that this signalling mechanism will be somewhat muted by the 'smoothing' of rent paths discussed above. However, so long as rents are rising the proper signal is sent, although its intensity may be lessened by smoothing. Under the Commission's proposal, pricing signals from the housing market itself are absent.

This regime also avoids the possible litigation costs of conventional rent control. Epstein suggests that litigation over evictions will rise if rent control keeps rent below market levels, as landlords will prefer to evict and convert apartments to alternative forms of housing, such as condominiums, unconstrained by rent control. Under this system, however, landlords will receive the market rate of return and will thus not attempt to evict in order to reap a higher return in alternative forms of housing.

A potential problem with the proposed regime, however, is opportunism in areas other than price. Specifically, the landlord may refrain from maintaining a residence, knowing that the price increase will be set by a central board regardless of maintenance. First, this is mitigated relative to other rent control regimes that do not allow market mechanisms to set the rent in a vacated apartment. Given that a landlord will go to the market every time a tenant changes apartments, he or she must be sensitive to maintenance or rent for the next tenant will be lower. Second, to the extent that shirking on maintenance is not disciplined by the market when tenants change, any problem that remains is identical to that present in any long-term contract. The coal company, rather than raising price, may offer lower quality coal to the electric company. As with these contracts, there must be some monitoring mechanism. For example, tenants may be given a grievance procedure. If a residence is poorly maintained, the landlord could pay compensation to the tenant. In order to reduce unmeritorious complaints, a tenant could pay costs to the landlord if the decision goes against the tenant. While this admittedly increases the cost of the system, the same problems would exist in any long-term contract.

2. *Error and Administrative Costs*

The rosy picture presented of the world under this regime must be tempered somewhat by the presence of error and administrative costs.

First consider error costs. In administering this rent control regime, it is inevitable that the authority responsible will occasionally misread the market and set a rent increase different from that which the market would set. With respect to long-run distortions in the supply of housing, these mistakes are irrelevant so long as the set rental increase is an unbiased estimator of the market increase (and construction firms are risk neutral). A developer will determine the expected value of rentals from a unit before building, which, so long as the authority does not systematically underestimate or overestimate the market increase in rental, should be identical under the regime as under a market free of imperfections.

Short-run distortions may occur, however. A rental increase set by the authorities may not reflect market conditions accurately, and relative prices between housing and other goods may be skewed, causing a misallocation of resources. This, however, should not be a serious concern. First, the authority may correct a previous mistake such that the effects of a mistake should not be enduring. Second, such distortions frequently result from long-term contracts. If the coal mine and the electric company set prices in their long-term contract so as to overcome opportunism, there is a chance the prices they set will not accurately reflect the market price of coal in the future. These distortions are accommodated, however, in order to overcome the hold-up problem. This should be so with rent control as well.

There will also be administrative costs associated with this regime. In order to set rent increases that approximate the market, the rent control authority must gather data on the level of initial rents each year. Furthermore, the authority must standardize these rents so as to generate an appropriate comparator with the previous year's rents. This could be accomplished crudely, simply by ensuring that the rent data are gathered across a cross-section of apartments. Alternatively, some attempt to construct an index based on the features of each apartment (a 'hedonic price index'[79]) could be made in order to standardize rents across apartments. The choice of method should be based on an optimal trade-off between the error costs and administrative costs associated with a particular technique; these costs are presumably inversely related.

3. *Empirical Evidence*

One of the central submissions of this paper is that rent control may substitute for long-term contracts in the rental housing market and thereby avoid hold-up problems. Commentators, such as Olsen, have suggested, however, that:

> [I]t is...well documented that sitting tenants pay lower rents than new tenants for identical units. This argues against the widespread belief that landlords have market power over sitting tenants due to the out-of-pocket and psychic costs of moving.[80]

Several studies have indicated that perhaps this hold-up problem is not of significant concern empirically since landlords in fact offer sitting tenants discounts relative to the prices charged to new tenants.[81] For example, Goodman and Kawai estimated the change in rent against the length of tenure in a rented apartment. They gathered data from several U.S. cities and concluded that, relative to the rent charged to new tenants, rent actually falls by about one per cent for every year of tenancy.[82] If this were true, there would be little justification for rent control.

Marshall and Guasch, however, point out that this and other studies are flawed.[83] There is a causation problem in assessing whether the apparently lower rents resulted from the length of tenure, or whether the longer tenure resulted from the low rent. If high rents were demanded of tenants, it would be only logical that the length of tenure would be shorter in these units. As Marshall and Guasch state:

> Tenants who were asked high rents at the time of contract renegotiations, on average, vacated their units because these new rents exceeded their offer rents. Therefore, what will be observed in units occupied for more than one contract period were, on average, tenants who received rent discounts from landlords, or, at least were not charged premiums. Hence estimating...a regression of log rent on unit specific characteristics and length of stay of the current tenant from cross section data must yield the result that

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[79] See A. Goodman, "Hedonic Prices, Price Indices and Housing Markets" (1978) 5 *Journal of Urban Economics* 471.

[80] E.O. Olsen, "Is Rent Control Good Social Policy?" (1991) 67 Chi.-Kent L. Rev. 931 at 937.

[81] See I. Lowry, "Rental Housing in the 1970s: Searching for the Crisis" in J. Weicher, K. Villani & E. Roistacher, eds., *Rental Housing: Is There a Crisis?* (Washington: Urban Institute Press, 1981) 23; A. Downs, "Some Aspects of the Future of Rental Housing" in Weicher, Villani & Roistacher, *ibid.*, 85; A.C. Goodman & M. Kawai, "Length-of-Residence Discounts and Rental Housing Demand: Theory and Evidence" (1985) 61 *Land Economics* 93.

[82] Goodman & Kawai, *ibid.* at 95.

[83] R. Marshall & J. Guasch, "Occupancy Discounts in the U.S. Rental Housing Market" (1983) 45 *Oxford Bulletin of Economics and Statistics* 357.

> the coefficient of the latter variable is negative. This would hold even if the pervasive tendency was for landlords to try and charge premiums to sitting tenants![84]

They then proceed to analyze U.S. data on housing rates correcting for this bias in the data. They conclude that:

> [W]e have insufficient evidence to conclude definitively that landlords do or do not offer residency discounts.[85]

This conclusion weakens the assertion of Olsen and others that the hold-up problem in housing should not be taken seriously because empirical evidence contradicts its existence. Indeed, the evidence about the costs of moving to tenants mentioned above (20 per cent of renters with an average monthly rent of $443 would not move if fully compensated for pecuniary moving costs as well as a $10,000 payment[86]) suggests that the opposite is true: the hold-up problem should be taken seriously.

A further problem with analyzing rent data in markets where rent control has not been imposed is that the hold-up problem may have already biased the data. According to the above analysis, if there is no constraint on rent, landlords will be in a position to charge premium rent *ex post*. Tenants with high transaction costs of moving (Radinites) will therefore be more reluctant to rent. Tenants with low transaction costs (Epsteinians), on the other hand, know that they will simply move rather than tolerate landlord exploitation, so they are more willing to remain in the rental market. As a result, the rental market will shrink from the optimal size, and tenants that remain will typically have low moving costs. In such a market, it is not surprising that landlords are not in a position to extract *premia*, as those vulnerable to exploitation have protected themselves by (sub-optimally) staying out of the market. Thus, examining current markets where no rent control is imposed to determine whether discounts are present will be skewed by the absence of 'Radinites.' This bias also strongly challenges the claim that the hold-up problem is not a concern given the empirical evidence on the subject. The empirical evidence about the absence of benefits from the proposed regime is inconclusive.

4. *Conclusion on the Welfare Justification for the Proposed System of Rent Control*

The above analysis has indicated that there are likely significant benefits of the proposed system of rent control, such as overcoming the hold-up problem, without some of the disadvantages of traditional rent control, such as adverse supply effects. This conclusion is largely unaffected by empirical studies of the hold-up problem, which are afflicted with significant methodological flaws. The error and administrative costs of the system are unlikely to overwhelm these benefits. Errors may be corrected year to year and are unlikely to have a significant impact on the rental market. Administrative costs of the proposed system are also unlikely to be prohibitive. As Arnott states:

> The direct costs of administering second-generation rent controls [less restrictive versions than their predecessors] appear to be of secondary importance. (In Ontario, for example, they are about $5 a year per capita.)[87]

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[84] *Ibid.* at 359-60.

[85] *Ibid.* at 372-73.

[86] Knetsch, Kahneman & McNeill, *supra* note 66.

[87] *Supra* note 62 at 108 n. 20.

This conclusion is strengthened by the recommendations of the Commission of Inquiry in Ontario. It proposed a system of rent control that would require the investigation of the average costs of landlords in order to determine a 'fair' return to landlords. The 'fair return' would be "an amount equal to the aggregate landlords' costs including operating costs, investment in the property, capital value effects and tax effects."[88] The system proposed here, on the other hand, would simply canvas the rents charged to initial tenants in order to construct an index of rental housing prices. Cost and revenue effects would simply be incorporated in rent levels. Thus, the Commission's finding that the administrative costs of its proposed system are not prohibitive is likely much stronger with respect to the system proposed here.

In sum, the administrative and error costs of the proposed system are unlikely to outweigh its benefits. The above analysis has shown that it is plausible to conclude that the proposed system is desirable from a social welfare approach.

B. *The Proposed Regime from a Libertarian Perspective*

Epstein argues that rent control is an unlawful taking of private property without compensation for public purposes. This argument does not apply to the proposed system. Under the proposed regime landlords will expect to earn precisely what they would earn in a market free of imperfections. It is therefore unclear how rent control could be construed as a taking of a valuable asset. Rent control in this case allows market rents to be earned, while protecting tenants from landlord opportunism. It is not a taking. If, however, the proposed system is construed as a taking since the landlord's reversion interest is regulated by rent control, this taking has been justly compensated; unlike many rent control regimes, the landlord under this regime earns market rents.

C. *The Proposed Regime from a Personhood Perspective*

Radin suggests that rent control is an appropriate form of government intervention to protect the personhood aspect of residential housing. While not completely compatible with Radin's stated approach, in that it is utilitarian in nature, the hold-up argument for rent control takes Radin's concern for property and personhood seriously. While Radin would seek to keep rents as low as possible to protect personhood, the proposed regime keeps rents from rising above market levels, thus preventing the exploitation of the connection between property and personhood. Indeed, if one follows Radin's suggestion that efficiency losses be considered in deciding whether to impose rent control, the proposed regime may be a suitable compromise between the protection of incumbent tenants at all costs, and the dangers of exploitation in an unregulated market. Radin's implicit argument that protecting personhood is worthwhile from a welfare perspective resonates with the above analysis.

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[88] *Supra* note 19 at 203.

VI. The Current Rent Control Regime in Ontario and Suggestions for Transition

A. *The Current Regime*

Rent control in Ontario is governed by the *Rent Control Act, 1992*.[89] The following summarizes its major provisions with respect to rent control itself (enforcement and other matters are not summarized).

Under this Act, rent control applies to virtually all traditional landlord-tenant relationships; exceptions are limited to hotels, hospitals and other types of housing outside typical definitions of residential housing.[90] Under section 12(1), the guideline for the allowable percentage rent increase for a given year is determined by summing two per cent for capital expenditures and 55 per cent of the percentage increase in an operating costs index determined each year by the Ontario Government. The rent for newly constructed units is determined by the market, but rent on existing units is set by past allowable rent increases, whether or not there has been a change in tenants.[91] Under section 13, if a landlord is dissatisfied with increasing rents by only the guideline rate, she or he may apply to the Chief Rent Officer for an order increasing the maximum rent for the unit. This application, however, will only be successful if based on increased costs for the landlord, such as an extraordinary increase in taxes,[92] or capital expenses.[93] Conversely, a tenant may apply under section 23 to the Chief Rent Officer for an order to reduce the rent for a unit as the result of reductions in the landlord's costs,[94] inadequate maintenance,[95] or reduced services.[96]

B. *Transition to the Proposed Regime*

Clearly there is significant divergence between the current Ontario regime and the proposed regime. While the above discussion has concluded that distributive justice concerns, such as the redistribution of resources from landlords to tenants and housing affordability, are inappropriate policy objectives for rent control, there is little doubt that the abolition of the present rent control regime would create much political controversy for such reasons. Moving from the present rent control regime to the proposed regime, however, would not only have the welfare advantages over complete decontrol outlined above, but would likely be more feasible politically. While the proposed regime is justified from an efficiency, social welfare perspective, it also has some politically desirable features.

Under the proposed regime rents are prevented from rising above their market rates, and if there is a sudden demand shift, rents are temporarily set below market rates in order to smooth the transition to a new equilibrium. Under this regime, tenants are protected from politically unappealing phenomena such as economic eviction as the

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[89] S.O. 1992, c.11 [hereinafter *Rent Control Act*].
[90] *Ibid.* at ss. 3(1).
[91] *Ibid.* at s. 10.
[92] *Ibid.* at s. 14.
[93] *Ibid.* at s. 15.
[94] *Ibid.* at s. 24.
[95] *Ibid.* at s. 25.
[96] *Ibid.* at s. 26.

result of idiosyncratic rent increases, exploitation of tenant personhood through high rents and transient spikes in rental rates. There will also be the political value of the absence of a perception of greedy landlords increasing rents at will, since rents are externally controlled. Shifting to the proposed regime from the current inefficient regime may therefore be politically palatable.

In order to minimize the economic and political costs of such a transition, the following policy is suggested. Immediate decontrol would likely have significant costs. The disruption implied by an immediate jump in rents would be harmful to households that have not had time to analyze the implications of higher rents; a gradual increase would be preferable. Thus it is proposed that rents be allowed to increase at a rate below some ceiling rate set each year (Smith suggests a rate two per cent or three per cent above the Consumer Price Index[97]) until the market rates are reached. Rather than a sudden jump to the market rate, rents will increase gradually to their market rate. The concern about disruption, however, does not appear to apply to new tenants, who have already assumed the burden of changing residences. The first period's rent on vacant units, as with the first period's rent on newly built units in Ontario currently,[98] therefore, should be decontrolled. Aside from creating an added incentive to build and to properly maintain units given the discipline of the market when the apartment is vacated, decontrol of vacant apartments has the added benefit of allowing the rental authority to gauge the market level of rents, as opposed to the level set by previous rent controls. Thus, the authority could allow rents on occupied units to rise gradually until they reach some market level determined by reference to decontrolled vacant units. From this point on, the proposed regime may be followed: market rates prevail on vacant apartments, and an index of market rental rates governs future rent increases in occupied apartments.

While redistribution and affordability are inappropriate objectives for rent control, they will clearly be affected to some degree by a shift to the proposed regime (although, as the evidence presented by Stanbury and Vertinsky indicates, not to the extent many might believe). The government must be prepared to compensate by increasing housing affordability programmes for low-income residents, perhaps, as the Ontario Commission of Inquiry suggests, by establishing a shelter allowance for those in need. The overall social costs of a more precisely targeted affordability programme will be far less than the distortionary rent control, which in fact disproportionately benefits the economically well-off,[99] that is currently the law of Ontario. If these programmes are instituted swiftly, the political costs of transition may also be minimized.

VII. CONCLUSION

The above analysis has attempted to justify moderate rent control with the central purpose of overcoming potential hold-up problems in the provision of rental housing. From a welfare viewpoint, the regime appears to provide various benefits, such as overcoming hold-ups, without the disadvantages of traditional rent control, such as adverse supply effects. Furthermore, error and administrative costs are unlikely to

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[97] L. Smith, "Rent Control and Program for Decontrol in Ontario" (Paper presented at the Conference on the Economics of Regulation and Deregulation, Faculty of Management, Univeristy of Lethbridge, 21-23 September 1989) [unpublished], cited in Stanbury & Todd, *supra* note 38 at 140.

[98] *Rent Control Act*, *supra* note 89 at para. 10(2)(b).

[99] See Stanbury & Vertinsky, *supra* note 53.

overwhelm these benefits. The regime has the additional appeal of addressing the objections of Epstein and other libertarians that rent control is a taking of property. Since landlords earn what they would otherwise earn in a market free of imperfections, the proposed regime of rent control is not a taking. Finally, the regime takes seriously Radin's argument that personhood and residential housing should be protected. Landlords in this system are prevented from exploiting the 'self-investment' of tenants in their rental homes.

In order to shift to the proposed regime in Ontario, rents should be allowed to rise gradually on occupied units until they reach market levels, while rents on vacated and new units should be determined by the market. At the same time, the government should implement an affordability programme, perhaps a shelter allowance, for low-income residents to compensate for the removal of rent control. After the transition is complete, rent increases on occupied apartments should be determined by reference to a market index constructed from the rental rates on vacated apartments; this regime would be a desirable improvement over the regime found in Ontario currently.