Economy and legal aspects of private rental housing and the importance of proper adjustment of market rents

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ABSTRACT
In order to attract investors, rental housing just like any other business, has to offer reasonable security of investment and reasonable return on invested capital. At the same time, housing often attracts heavy political interference of governments because of the commonly spread socialist or even communist doctrines and public pressures calling for the provision of housing as a cheap or nearly free service for the electorate public.

In Europe we have adopted after the end of the second-world-war the Convention for the protection of human rights and fundamental freedoms, which became an obligatory part of constitutional law of all EU member states. This Convention in its first protocol guarantees in its article No. 1 the peaceful enjoyment of every person’s possession, including rental housing units.

Based on this, all European countries should obey this binding law and the governmental interference should be kept within reasonable limits to allow peaceful enjoyment of everyone’s property. Unfortunately, reality does not always reflect this. Many countries are still keeping in force legal and economical regulation of rental law and rents far beyond the acceptable limits. In this contribution we will concentrate on setting the limits of interference that is still admissible in private rental housing in Europe in order not to completely destroy the rental housing.

Rental housing is without doubt the best and cheapest solution for housing low income households but also for housing some high income families, which are looking for the easiest method to find and to maintain housing in their main search for the best paid but time consuming jobs or the best location for their business. It is also the best economic solution from the point of view of the effective use of free capital available to the richer population and lack of capital for the poor. It may be a relatively low risk opportunity of investment of capital for others. The use of the free capital to build rental housing is a much cheaper solution than using any mortgage financing and under normal legal conditions protecting property rights it should represent a reasonable investment with low, but usually safe income without any mandatory training for the job. Sometimes during prosperous times it may even offer an additional capital gain.

Forcing all to invest their savings into home-ownership is bringing huge profits to the mortgage banks and building industry, but it may prove dangerous when the offer of available housing is not adequate to the demand, as was clearly the case during the recent residential housing crisis in the USA. It turned into a serious global recession with devastating effect on the US economy. Home-ownership is definitely not a good solution for all low income families especially if the government is encouraging them with subsidies and/or tax incentives to invest into home-ownership even when it exceeds their financial possibilities and at the same time encouraging the banks to offer mortgage loans even to those who may be unable to pay back their debt.

This tendency of pushing even the poor to opt for home-ownership is based on lobbying pressure of the building industry and some mortgage banks in a false political calculation that during their economical active years they will acquire their own housing and the government will save on social housing allowances when they retire. When they are not able to pay the cost of their housing it will be more or less their problem with an option of selling their homes and going for rental housing with the released equity. Often the need for financial solution comes when the house is still the property of the bank and the following execution is a much worse solution than losing rental housing that is too expensive. Most countries have in their constitution and international agreements an obligation for the state to help all in social need, so that they are able to live in decent conditions, including housing. It should be therefore of economic interest for all governments to save on their budget by cancelling
expensive subsidies offering rent regulated (“social”) housing which is very often occupied also by high income families or offering low quality housing in deprived locations. This policy of offering cheap accommodation in rent regulated (“social”) housing is only inspiring certain segment of population to observe the conditions necessary to convert a temporary social help into a permanent income. We have to admit, that the proper solution based on personal housing allowances may also have problems if the allowances are poorly designed with insufficient means testing (income as well as assets), or if the allowances are too low or too high as related to the normal local rent or offered for too long term. Governmental incentives helping the banks to lend to anybody may easily lead to the collapse of banks and the ensuing much more expensive compensation of these losses from the taxpayer’s money.

What are then the necessary conditions to persuade the private capital to build sufficient but not excessive number of rental housing units offered for low but sustainable rents?

Economic analysis of rental housing and “fair rent” calculation

The largest part of the misunderstanding in the debate about rental housing is caused by poorly defined meaning of the fundamental terms. We will therefore concentrate on a detailed explanation of what we are speaking about.

**Actual Reproduction Value (ARV)** of a rented property is the amount of money that would be necessary if you would like to build a similar property now.

**Actual Market Value (AMV)** of a rented property is the amount of money that it would cost you if you would like to buy the existing property now.

**Cost of Simple Reproduction (CSR)** is the amount of money averaged over the lifetime of the property, needed to cover the yearly cost of repair, management, taxes, insurance, maintenance, legal services, loss of rent because of vacancies or uncollectable claims, and regular renovations in case of change of tenants which are necessary in order to keep the apartment in the same state of perfection as at the beginning of the lease plus depreciation of the ARV of the property necessary to provide funds for systematic modernization or demolition of the building and construction of a similar replacement structure at the end of its lifetime (100 years).

**Core Rent (CR)** is the reward to the landlord above the cost of simple reproduction, for letting the tenant use his property. It is equivalent to the interest paid by a borrower to the bank for the right to use the borrowed money for the whole time before the amount is returned back to the bank.

**Cost of Services arranged by the landlord for the tenant (CS)** these payments are sometimes also collected by the landlord together with the rent, but are in fact paid to the suppliers of these services such as heat, gas, electricity, water, garbage disposal, pay TV etc.

**Valorization of rent** is the nominal increase of rent introduced in order to keep the real value of the rent constant. Valorization is usually linked to inflation, increase of the cost of housing construction works or increase of mortgage interest rate.

**Rent increase** is the increase that increases the real value of the rent (exceeding the valorization) either when the AMV of the rented apartment increases, because of investment into the house or apartment or the value of the house increases because the location becomes more attractive. In this case the return on investment remains usually unchanged.

**Fair rent** is an artificial construction of a rent that is believed to be fair both to the tenant and to the landlord. The fair rent set by the authorities is very often substantially lower than is fair to the landlord. Nevertheless there is an acceptable way to find a reasonably fair rent. It is based upon the principle of zero return from zero investment. Such a fair rent may be also used successfully for well functioning rent regulation, if need be.

**Social housing allowance** is a temporary individual income gap, means tested, financial supplement making reasonable housing standard, offered for usual market rent, affordable even for people with limited income.

**Affordable housing** is every housing, offered for standard market rent, providing all tenants have been granted such social housing allowance to be able to afford reasonable standard of such housing according to the size of their household in any location where they have found a job.
Market rent is a rent that is regulated only by market principles of demand and supply. Because the resulting value of rent is predominantly set by the tenant’s willingness to pay such a rent, it is his calculation that is decisive. He has either the possibility to buy the apartment and after paying back his mortgage and cost of his apartment will pay on a regular basis only the cost of simple reproduction (CSR) of his apartment and services (CS), or he may rent the apartment and pay only rent, including also the core rent (CR) and (CS).

The rule of thumb states that the rent should not be higher than some 5% of the AMV of the apartment for expensive housing and some 8-10% for cheap housing. Let us now turn to the structure of the regular payment RP, that the tenant is paying to the landlord and that is sometimes erroneously called “rent”.

\[ RP = CSR + CR + CS \]

The term CS is definitely not any part of the real rent, because it represents only the income of other institutions that do not influence the availability of housing or level of rents, therefore the real rent \( R \) is only \[ R = CSR + CR \]

CSR has been calculated by many different organizations all over Europe and the results are nearly the same for brick and stone structures in central Europe

\[ CSR = 3\% \times ARV \]

ARV is of course lower in Southern countries with milder climate and higher in Northern countries. Let us turn now to the core rent CR.

\[ CR = \text{approx. 3-5\%} \times AMV \]

This is the gross income of the landlord before taxation or it is sometimes called the gross return on investment into renting. Depending on the level of taxation, it provides the landlord with full return on his investment in some 30 years as compared to some 7-10 years in the case of other business activities. Under undistorted market conditions CR should be at least as high as the interest rate of long term deposits (3%) and is always slightly below the interest rate of mortgages (5%) and is usually following this value with some delay. The only argument for investment into such low income activities is a non-guaranteed capital gain which may under certain conditions increase or decrease the return on investment.

Let us now turn to the fair rent calculation using the principle of zero profit from zero investment. Let us suppose that the investor has borrowed money, using a 100% mortgage loan and bought the apartment for the market value(AMV). The requirement of the bank is that he properly uses the whole CSR in order to keep the forfeit in good condition and that he pays the bank the usual interest rate from the AMV of the apartment. In case that the CR = mortgage interest rate, the investor is getting no profit for himself because all the amount exceeding CSR is the income of the bank. If CR is lower than the mortgage interest rate, he is losing and would the CR be higher than the mortgage interest rate he would gain without investing his own money.

By taking \( CSR = 3\% \times ARV \) and setting the \( CR = \text{usual mortgage interest rate} \) we get a very good approximation of the upper limit of a fair rent and at the same time the cost of such housing becomes definitely cheaper than any subsidized housing, where all the cost is included.

It is therefore not surprising that even in the countries, where there is no rent regulation for the private rental sector, the market rents automatically adjust slightly below this value, because if it were not the case, investors would be strongly attracted by the possibility of having profit from zero investment.

The economy of subsidized housing (sometimes called “social”) is exactly the same. The invested public funds if invested anywhere else would bring at least 5% p.a., this loss must be taken into account. The CSR is the same if the maintenance is not neglected and therefore the cost of housing would be at least the same as in the case of commercial rental housing. The ARV of similar new apartment (AMV = ARV) would be the same, but since the investor is not investing his own money
the cost of a similar structure is usually higher. The published data from the USA show some 50% higher cost while similar data from Germany talk about 30% increase. This value depends on the level of corruption in the country in question. Also the accepted quality of the housing stock is lower in case that the responsible person is not accepting the lower quality of its own property. Because the housing is offered for below market prices also the tenants do not feel that they should have any pride in the perfect state of their luxurious dwellings and do not pay that much attention to keeping their apartments in good condition as people paying the full price for their housing. The greater concentration of low income families and problematic tenants also results in higher level of vandalism and the weaker feedback between the management and the tenants as compared to landlords living in the same house and taking care of their own property, leading to greater anonymity of misconduct and faster deterioration. Summing up we find that the subsidized ("social") housing costs the taxpayer at least 50 - 100% more than in the case of wisely designed means tested temporary individual social housing allowances (not available to those wealthy households that still occupy "social" housing) for adequate standard of living for usual market prices and without the social exclusion connected with subsidized housing. The only advantage of subsidized public housing is that it does not force problematic tenants, criminals, drug addicts etc. to behave decently as is required in the commercial rental sector.

Multiple studies, reported by George Galster in 1997, Housing Studies 12, p.561-578, show, that personal housing allowances turn out to be twice cheaper than subsidized ("social") housing policies with the same effect.