

# **Proposals for regulation of the private rented sector: an analysis**

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# Executive summary

## The question

The National Landlords Association commissioned this research in order better to understand the various policy proposals put forward in the last year in relation to the private rented sector. This interim report reviews the content of proposals that emerged before the UK national elections and summarises the relevance of international experience to these proposals.

## Methods

We gathered information about policy changes proposed by political parties and interest groups, then carried out a short review of existing evidence about the effects of the policies proposed. We looked at evidence from the UK and from other countries where similar, or apparently similar, policies are already in place, and developed a framework with which to analyse the impacts of policy change.

## Manifesto proposals

The proposals in the manifestos of political parties related largely to length of tenancy and associated rent regulation. All parties wanted to see longer leases and more predictable rents within the tenancy period, but the proposed implementation methods varied. Suggestions ranged from voluntary model tenancy agreements to compulsory three- to five-year leases with indexed increases within the tenancy. Plaid Cymru advocated rent limits on new tenancies and the Green Party said they would consider them, but the main political parties did not advocate rent limits on new leases.

## Framework for analysis

Landlords' responses to changes in the regulations around tenure security and rent increases would vary depending on their reasons for being in the sector. Those seeking a secure income stream (which includes most institutional investors) would be less affected—and indeed might in some cases consider the changes beneficial. Landlords looking mainly for capital gains would find their options reduced. All types of landlord could be expected to respond negatively to uncertainty about policy reform.

Many tenant households want the freedom to move and would gain little from longer tenancies and within-tenancy rent stabilisation. However an increasing number of households, especially those with children, would benefit from greater long-term security and stabilised rents.

## International experience

*Ireland* apparently provided the model for the Labour Party's proposals. Since 2004, Irish landlords must register tenancies and rents. After a six-month probationary period tenancies last four years. Rents can move down or up (although not above market levels) on a yearly basis. Ireland is now experiencing a housing crisis with rapidly rising rents and some pressure to increase controls.

*Germany* is often cited as the best example of a country with a stable private rented sector that houses a full range of households. Tenancies are indefinite and rent rises within the tenancy are related to local average rents. However initial rents may be well above current market levels in areas of high housing pressure. Most landlords do not provide white goods and may not even supply

fixtures and fittings. One reason the system has worked well is that in most parts of Germany house prices fell for many years. Now there is upward pressure on prices in some cities which has resulted in shortages of rental properties, rising rents and political pressure for stronger controls. In Berlin and some other cities, rent increases on new leases are now limited to 10% above the local market rent.

**France** has had no initial control on rents for properties let since 1948. The typical lease lasts three years, and since 2008 annual rent increases have been indexed to the cost of living. There has been pressure to introduce controls on initial rents in a number of high pressure areas. As of April 2015 it was expected that these controls would be limited to Paris.

In **the Netherlands**, rent and tenure regulations apply equally to the private and social rented sectors. Leases are indefinite. All rented dwellings are scored using a points system; the number of points indicates the maximum allowable rent. Rents below €700/month are controlled by the government, while higher rents can be freely set. There is an incentive to improve properties so that they are removed from control. The private rented sector is small and shrinking.

**San Francisco** provides one of the best examples of traditional rent control for the bulk of rental apartment buildings. Leases are indefinite and in-tenancy controls on increases hold them well below market levels. There are massive shortages of rental properties and strong incentives to evict tenants by paying compensation. Rent controls are a highly political issue.

### ***Tax reliefs***

Most developed countries treat privately rented property as an investment good for tax purposes. The main area where tax treatment differs is whether depreciation (especially accelerated depreciation) can be deducted from the landlord's income for tax purposes. In Britain it cannot except for wear and tear in furnished accommodation. In most other countries it can.

### **Implications**

- The effects of PRS regulation are very strongly conditioned by the national and local legal, fiscal and cultural environment.
- There are increasing political pressures to increase *initial* rent regulation because of steep rent increases, even in many countries with well-established rent stabilisation policies,
- The UK is rather unusual in that it is simple and frictionless to transfer a dwelling between owner-occupation and the private rented sector and vice versa.
- Changes in regulation that negatively affect rents and yields, or risk and confidence, can be expected to reduce supply and make it harder for new tenants to find accommodation.

## Background

Housing policy, and particularly the role of the private rented sector (PRS), was a key issue in the debates leading up to the general election. This was driven partly by the situation in London and the south east, where property prices and rents continue to rise, but also by issues around transactions costs, taxation, retaliatory eviction and value for money. Much of the political debate centred on the problems facing those households—especially families with children—who prefer stable, long-term housing but are unable to access either owner-occupation or the social rented sector. The existing model of short-term tenancies and unregulated rents was said to serve them poorly, and the pre-election debate showed there was increasing interest in modifying the system.

Political parties and interest groups differed about whether the system should be changed, and if so how best to do so. The National Landlords Association commissioned this research in order better to understand the policy proposals that were put forward in relation to the PRS. We were asked to explore the likely economic and social effects of the measures on various market actors including landlords and tenants, but also on other housing providers and government bodies. The emphasis in this interim report is on the range of proposals put forward before the UK national elections and on the relevance of international experience to these proposals.

The London mayoral election will be held on 5 May 2016, and several of the potential candidates have already spoken of their intention to change the regulation of the PRS in the capital city. In the final report, to be published later this year, we will examine the case of London in more detail, looking at the situation of renters in the city and the various proposals for change.

## Methods

We gathered information about policy changes proposed by political parties and interest groups, then carried out a short review of existing evidence about the effects of the policies proposed. We looked at evidence from the UK and from other countries where similar, or apparently similar, policies are already in place,

Drawing on this material and the analytic literature on the PRS, we developed a framework which helps to assess the likely impact of individual policy changes on the incentives of different groups of landlords to provide accommodation and on different groups of tenants to demand that housing, and thus on the price and availability of private rented accommodation.

## Proposals for change

The campaign leading up to the May 2015 general election demonstrated the range of policy ideas with political currency. Some of these ideas had a long incubation period at London level as well as nationally—see for example the 2013 report of the London Assembly, which called for the introduction of some form of rent stabilisation in the capital (London Assembly 2013). The proposals of the main political parties developed as follows:

### *The Labour Party*

In 2012 the Labour Party conducted a policy review of private rented housing. This produced a series of documents about different aspects of the legal and regulatory framework, including lettings agents, standards and (most relevant for this report) ‘providing stability and affordability for renters and families’ (Labour Party 2012). The report set out the case for longer tenancies for tenants who

wanted them, saying that ‘rent could be indexed for the duration of that tenancy. We will consider the most appropriate type of indexation...’ (ibid p. 10). It outlined various possible approaches, from ‘voluntary, incentive-based system to an approach that grants renters more rights in law’. Local authorities might be allowed to decide whether to implement longer tenancies and predictable rent increases in their areas (ibid p. 10).

In return for possibly requiring landlords to offer longer leases, the document said ‘Labour will work with the (landlord) sector to develop a range of possible incentives that will form part of a “something for something” deal for landlords’. These incentives might include supplying tenants from local housing registers, direct payment of housing benefit to landlords, and an easier eviction process for tenants who caused damage or ASB. Finally, the document floated the possibility of changing the fiscal regime for landlords to bring it more into line with practice in other countries. This might include introducing depreciation allowances and so-called ‘negative gearing’ (allowing rental losses to be offset against other types of income for tax purposes). It also mentioned the possibility of ‘making any current benefits of the tax system contingent on landlords offering longer-term stable tenancies’ (ibid p.11).

In a press release about an April 2014 speech by Ed Miliband, the party provided more details, saying it would legislate for three-year tenancies after a six-month probation period. Rent increases would be limited within the tenancy, ‘based on a benchmark such as average rents’. Landlords would be able to remove tenants at the end of the probationary period, or for specified reasons within the tenancy with two months’ notice. Tenants would be able to leave at any time with one months’ notice.

In February 2015, with the election approaching, the Labour Party made its policy more explicit. Its website said the party would ‘change the law to make three-year tenancies the norm’ while allowing both landlords and tenants to terminate the contracts earlier with proper notice if they needed to, ‘just as they can now’. It suggested that rent increases within the tenancy would in the first instance be limited to CPI (<http://www.labour.org.uk/issues/detail/renting>). In addition, tenants would be given a legal right to know how much rent was paid by the previous tenant, in order to help them negotiate the best initial rent.

Labour leader Ed Miliband announced that if elected he would institute a compulsory national register of private landlords. This register, he claimed, would help HMRC collect some £100 million of tax that landlords had avoided; the money would help fund a three-year stamp duty holiday for first-time buyers. He also stated that the party would reduce tax relief for the upkeep of furnished properties that were found to be substandard.

### *Conservative Party*

Communities Secretary Eric Pickles, in a 2013 speech, introduced the idea of a ‘tenants’ charter’ that would give renters the right to request longer tenancies (three to five years). He said the government would develop a model agreement for longer tenancies within the existing legal framework. In September 2014 the Department for Communities and Local Government published this model tenancy agreement, which it said was ‘particularly focussed on supporting tenants who want to negotiate a longer fixed term period at the start of the tenancy’ (DCLG 2014). The document sets out the benefits of longer tenancies, saying

‘The Government recognises that there is growing interest in tenancies that have a longer fixed period – e.g. three years. Such agreements can give tenants – particularly families with children – greater certainty and stability to plan for the future. Entering into longer tenancies is also beneficial to landlords as it offers greater certainty on rental income,

minimises periods when the property is vacant and avoids the costs associated with finding new tenants. It also means that neither tenants nor landlords need to pay fees to renew a tenancy.’ (ibid p. 1)

This model contract does not specify a period. It suggests that for terms of less than two years, the rent should remain the same throughout, while longer tenancies should permit a maximum annual rent increase—either a fixed percentage or by CPI. For tenancies of two years or longer under this model agreement, the tenant is permitted to break the tenancy with three months’ notice at any time after the first three months. Landlords have a one-off break clause at six months, and also may gain possession for specified reasons (e.g. non-payment of rent) at any time.

### *Liberal Democrats*

The Liberal Democrats proposed a Help to Rent scheme for young people. This would provide low-interest tenancy deposit loans of up to £2000 (in London) for first-time tenants under the age of 30. They said they would implement a new multi-year tenancy with inflation-linked annual rent increases. They would also allow tenants to reclaim their rent from landlords whose properties had serious health risks, and withhold rent if landlords did not carry out court-mandated improvements expeditiously.

One of the Liberal Democrats’ most publicised policies, the ‘rent-to-own’ proposal, would not have affected private landlords as it would have been run in collaboration with housing associations.

### *Green Party*

The Greens proposed five-year tenancies with inflation-linked increases. They also promised to establish ‘Living Rent Commissions’ that might propose policies to bring rents into line with local incomes. They pledged to remove tax relief on mortgage interest payments for private landlords entirely, using the money thus raised to fund construction of new social housing.

### *Plaid Cymru*

Plaid Cymru pledged to introduce minimum 18-month to two-year tenancies and rent control, although it did not provide details of how this would work.

### *Other issues*

During the campaign there was almost no discussion of no-fault eviction at the end of a lease, or indeed of retaliatory eviction (which was to some degree addressed by changes put in place by the coalition government).

If three-year leases did become the norm, there would be a question as to how market rents for extension should be determined. Going forward, this and other issues are likely to generate a range of uncertainties.

Table 1 summarises the main pre-election proposals around tenancy security and rent regulation, including some proposals from think tanks, advocacy groups and Parliamentary committees.

**Table 1: Pre-election policies on PRS tenancy length and rent regulation: Political parties, advocacy groups and Parliamentary committees**

<i>Organisation</i>	<i>Policy issues</i>					<i>Voluntary or compulsory?</i>
	<i>Longer tenancies</i>	<i>Rent on new tenancies</i>	<i>Regulate increases within tenancy</i>	<i>Ending tenancy before term</i>		
				<i>By tenant</i>	<i>By landlord</i>	
Labour Party	3 years including 6-month probation	Market	Yes; initially limited to CPI	One month's notice	At six months if tenant 'fails', or after with two months' notice for specified reasons	Compulsory
Conservative Party (current government policy)	Model tenancy. No specified term but intention is more than two years	Market	Yes, either by fixed percentage or CPI	Three months' notice	After six months, or later for specified reasons including non-payment of rent or sale of property	Voluntary
Liberal Democrats	Model 3-year tenancy with 6-month break		Yes by inflation			Voluntary
Green Party	Five years	Possible future caps				Compulsory
Plaid Cymru	18-24 months	Controlled	No details			Compulsory
Shelter	Five years		By CPI	Tenant can give two months' notice at any time	Landlord can break tenancy to sell property	3 options: <ul style="list-style-type: none"> <li>• Voluntary;</li> <li>• Voluntary with tax incentives;</li> <li>• Default</li> </ul>
Crisis	By mutual agreement using existing options		By inflation	Under certain circumstances—e.g. need to move	Landlord can break if needs to sell for financial reasons	Govt should 'encourage and incentivise'
CLG Select Committee	Yes using existing options; no term defined		By inflation, wages or fixed percentage			Voluntary

Sources: De Santos 2012; Crisis 2013; House of Commons Select Committee 2013; NLA 2015; party manifestos

## Framework for analysis

In looking at the potential effects of policy changes we could simply do a broad-brush examination of expected impacts on landlords and tenants. However, within each group there is huge diversity of financial position, expectations and attitude to risk and return. Grouping stakeholders in terms of their primary interests helps us to identify the parts of the market that would be most affected.

Landlords can be categorised into three main groups: those who are landlords because of accidental/non-business reasons (e.g. inheritance, planned use in retirement or for children); investors looking for total return including both capital gains and rents (who traditionally have relied more on increases in housing values); and long-term investors looking for a secure rental stream. The vast majority of landlords own only a few, indeed often just one, property. Larger landlords usually have more experience of management and intend to be in the market for the longer term. Table 2 lists the main characteristics that could affect the way landlords respond to regulatory and taxation changes.

**Table 2: Characteristics determining how landlords are affected by policy change**

<i>Characteristic</i>
• Type of owner: individual or company
• Investment goal: seeking income, seeking capital gain, or other motivation
• Portfolio size
• Time horizon for business: long-term or short-term
• Management: self-manages rental units or employs an agent
• Debt: mortgaged or outright owner
• Location of rented property: city, suburb, town, rural, pressured or lower-demand area

To simplify the analysis and relate it more closely to suggested changes we here restrict the analysis to a few composite types:

- accidental landlords;
- small individual landlords looking for capital gains (i.e. the average buy-to-let landlord); and
- larger more professional landlords of whatever type who view it as a long-term business.

In addition we include institutional investors, as there has been much discussion in recent years about attracting them to the sector in order to increase new output and improve management.

Policy changes affect landlords' investment decisions and therefore their preparedness to supply accommodation. The main factors they take into account are:

1. **Rents** (which feed into return)
2. The **running costs** of managing the property (which also feed into return)
3. **Length of tenancy** and therefore their ability to adjust portfolios by selling properties with vacant possession
4. **Security of tenure** and their ability to evict tenants or not renew tenancies
5. The **risk** that they might want to modify rents or sell up, or that hassle will be increased
6. **Confidence**—certainty about the outcome of change and the likelihood that further regulations will be put in place.

Table 3, based on the existing literature on the motivation and behaviour of private landlords, sets out the possible impacts of a package consisting of three-year tenancies; in-tenancy rent indexation (assumed to lead to below-market increases); and registration plus no fees to tenants.

**Table 3: Illustrative impacts of policy change on four types of landlord**  
*Package: 3-year tenancies, below-market indexed rents, registration, no fees to tenants*

<i>Investment decision factors</i>	<i>Type of landlord</i>			
	<i>Accidental</i>	<i>Small buy to let</i>	<i>Professional</i>	<i>Institutional investor</i>
Rents				
Running costs				
Length of tenancy				
Security of tenure				
Risk				
Confidence				

Key:

	Some	Considerable	Important
Costs			
Benefits			

Three things should be stressed:

- (i) the impact of limiting rent increases within a tenancy depends on the index chosen, actual running costs compared to the index, and alternative investment opportunities. Clearly there is a relationship between length of tenancy and the capacity to modify rents in line with costs and the market
- (ii) short-term impacts can be very different from long-term ones – most importantly because confidence will change, but also because people do not generally adjust quickly and other opportunities increase over time. Thus if underlying fundamentals change such that returns are lower and risks are higher, landlords will disinvest as opportunities arise
- (iii) institutional investors are not yet much in the market. The question is whether and how policy changes would affect their expectations. In our research for Homes for Scotland it became very clear that adequate yield and certainty with respect to regulation were prerequisites for large-scale investment (Whitehead *et al* 2013).

Like landlords, tenants are a far from homogeneous group. Some expect to live in the PRS for the long term and would benefit from policies designed to improve its ability to provide permanent homes. Others are in the tenure precisely because it is *not* permanent—they value flexibility and easy access. The average length of a tenancy is considerably longer than the current AST, but different groups assign very different values to certainty about lease extensions or renewals. Existing tenants with higher incomes and wealth have more choice in the residential market and are therefore more likely to have chosen private renting because its attributes suit their needs.

Table 4 sets out some tenant characteristics that may affect how they respond to new policies. Here we identify three groups:

- younger single households (often sharing), who usually expect to stay a relatively short time;
- family households looking for longer-term stability who cannot access other tenures; and
- employed households who are expecting to move on—although when may be unclear.

**Table 4: Characteristics determining how tenants are affected by policy change**

<i>Characteristic</i>
• Household characteristics
• Employment circumstances
• Prefer stability vs prefer flexibility
• Income

There are three ways in which the proposed package of policy changes might affect tenants. It could influence

1. their ability to *find accommodation*;
2. the *rent* they have to pay; and/or
3. their *certainty* about length of stay and rents.

Table 5 summarises the potential impacts of the same package of policy changes on the three categories of tenant identified above. The literature suggests that in this regulatory environment, the limit on rent rises within the tenancy will mean that *initial* rents on new leases will be higher than they otherwise would be – so tenants who are not looking for security end up paying more. How much more will obviously depend on the policies’ impact on the number of new lets and the extent of demand in the marketplace. Entry costs for tenants will be reduced directly by the removal of fees but will be increased indirectly if these are added to the rent and/or supply declines.

**Table 5: Illustrative impacts of policy change on three types of tenant**

*Package: 3-year tenancies, below-market indexed rents, registration, no fees to tenants*

		<i>Type of tenant</i>		
		<i>Short term</i>	<i>Families with few alternatives</i>	<i>Expecting to move on eventually</i>
<i>Factor affected</i>				
Rents				
Entry costs	Direct			
	indirect			
Length of tenancy				
Security of tenure				
Risk of eviction				

Key:

	None	Some	Considerable	Important
Costs				
Benefits				

What is obvious is that these proposals would mainly benefit tenants—but only certain groups of tenants. The extent to which new and short-term tenants would suffer would depend on the extent to which supply reduced and therefore initial market rents rose. As noted above, this in turn would depend on how quickly uncertainties about the changes in regulation could be resolved as well as on the opportunities to sell to owner-occupiers.

## International experience: tenancy length and rents

The following section briefly sets out the situation in five places where there is more legal control of rents and tenancy length than in the UK: Ireland, Germany, France, the Netherlands and San Francisco. This section draws heavily on Whitehead *et al* (2012), which contains a more general discussion of regulatory regimes across Europe, and on Scanlon & Whitehead (2014).

### Ireland

Ed Miliband pointed to Ireland as a model in terms of how it handles regulation of the PRS. In reality, Ireland deregulated and reorganised the market with the aim of generating higher quality rental housing rather than lower rents.

Rent controls were abolished in 1982 in Ireland, and since then rents have remained largely unregulated. The 2004 Residential Tenancies Act however did stipulate that initial rents could be no greater than the market rent, and that rents within a tenancy could only be changed once a year and could not be greater than the open-market rate (Department of the Environment, Heritage and Local Government undated). Landlords in Ireland are required to register tenancies and rents, and the Private Residential Tenancies Board produces market-rent statistics as a benchmark. Rents may be reviewed either up or down only once a year unless there has been a substantial change to the property. Tenants must be given 28 days' notice of new rents, and may ask for a review if they feel they exceed the market rate for the property. Disputes can be referred to the Private Residential Tenancies Board (PRTB).

Security of tenure was strengthened by the Residential Tenancies Act 2004, which introduced standard four-year tenancies. Landlords are permitted to terminate a tenancy without giving a reason during a six-month probationary period, but after that (and up to four years), the landlord can only end the tenancy for one of six specified reasons (non-payment of rent, overcrowding, intended sale etc.). After four years a new tenancy commences and the process starts again. Notice periods for both landlords and tenants increase in line with the tenancy's duration, to a maximum of 112 days for landlords and 56 days for tenants (Norris 2011).

There have also been significant moves in recent years to improve the minimum standards of private rented housing. Regulations introduced in 2009 aimed to improve cooking, heating and laundry provisions, set minimum space and storage provisions to facilitate family living, required landlords to maintain the exteriors of dwellings and completely phased out the traditional 'bedsit' (with shared facilities) by 2013 (Hayden *et al.* 2010).

The introduction of higher standards and increased security were generally welcomed and are thought to have improved conditions. However the PRS remains a relatively small part of the housing system, generally accommodating more mobile households but also a significant proportion of lower-income households who cannot obtain social housing.

Ireland is now experiencing a housing crisis that affects all tenures. Rents have been increasing rapidly, especially in Dublin, partly because of a near-standstill of new housing production. There is increasing political discussion about the reintroduction of some form of rent stabilisation. Under the existing system, rents within existing tenancies can only be raised once a year, but can go up in line with market rents rather than being linked to a cost-of-living index (as the Labour Party proposal envisioned). The Dublin market saw rent rises of 9.2% in the first seven months of last year, meaning that even sitting tenants experienced dramatic increases in rents. According to a recent government-commissioned report, 'There is a general consensus that the private rented sector

is in crisis in certain locations' (DKM 2014). According to the Irish press, the government is considering limiting rent increases to CPI unless there are significant upgrades to the property.

## Germany

In Germany as a whole nearly 50% of households rent their homes, and in Berlin the figure is almost 90%. Most rented housing is privately owned—even 'social' housing is owned by private investors (individuals or companies) and rented to low-income households for a limited period as a condition of subsidy. Many middle-income German families use rented housing as permanent homes. Security of tenure is strong and tenants can customise their accommodation, so renting has many of the features of owner-occupation in other countries.

Until recently, across Germany rents on private rented housing could be freely set on initial letting, although charging rents 'substantially higher' than the average for similar properties (in practice more than 20% in most areas [Kemp & Kofner 2010]) was a criminal offence. Recently however rapidly rising rents have brought pressure for change in some cities, and new rules allow municipalities with 'stressed' housing markets to limit rent increases on new leases to 10% over the average for similar properties. These rules have been adopted in Berlin, Hamburg and many cities in Bavaria and now cover about 4 million rental dwellings. Analyses undertaken just before the rules came into effect showed that in some areas most properties for rent (up to 86% in certain neighbourhoods) had rents in excess of what the new regulations would permit.

Within a tenancy rent rises are controlled in one of several ways, depending on the municipality. The lease contract may specify an annual rent increase (*Staffelmiete*) or state that rents rise in line with a cost-of-living index, but these options are little used. In practice most rents go up by the average in the local area. There are three methods: first, mirror-rent tables (*Mietenspiegel*); second, expert opinion; or third, looking at rents for three comparable units in the same area.

The *Mietenspiegel* system was set up in 1982 as a way to provide objective empirical data about local rent levels. About 300 municipalities produce *Mietenspiegel* tables, which they update every two years. These tables are based on data about dwelling characteristics and rent levels for tenancies started in the preceding four years. The information is provided by tenants and landlords' associations or, in bigger cities, comes from specially commissioned surveys. Some cities provide relatively simple tables relating rents to dwelling size and date of construction (e.g. Cologne<sup>1</sup>). Others produce what are known as 'qualified *Mietenspiegel*' based on hedonic regression analysis. These include a much greater range of variables.<sup>2</sup>

Rents can be raised at most once every 15 months, and by a maximum of 20% over three years unless the dwelling has been modernised or benefited from energy-efficiency investment. In this case the landlord can charge 11% of the investment cost every year. Because this is one of the few ways landlords can achieve significant rent increases it has led to a high level of energy-efficiency investment in the German rented stock.

German leases are indefinite—the tenant generally has the right to remain in the dwelling until he or she dies. Fixed-term contracts are only permissible in certain limited circumstances. On the death of a tenant the contract passes to the tenant's heir(s); the landlord is permitted to give notice and cancel the lease if the heir did not already live in the dwelling. The lease binds the new landlord if the dwelling is sold.

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<sup>1</sup> <http://www.koeln.de/immobilien/mietenspiegel.html>

<sup>2</sup> See for example information about the most recent *Mietenspiegel* survey in Munich here: <http://www.muenchen.de/rathaus/Stadtverwaltung/Sozialreferat/Wohnungsamt/Mietenspiegel.html>

There are a few specific reasons for which the landlord is permitted to evict a tenant: if the tenant has rent arrears of three months or more; if they are causing a nuisance; or if the landlord wants to use the property for themselves or a relative to live in. The landlord's notice period in such cases depends on the duration of the tenancy and is up to nine months. The tenant on the other hand can leave at any time with three months' notice. Tenancies can be transferred to another tenant with the landlord's permission.

German tenants and landlords expect properties to be rented for the long term, and to be in every sense the tenant's home. They are rented 'bare'—that is, they are unfurnished and usually do not even contain kitchens; the tenant is expected to purchase and install their own. This clearly affects the tenants' incentives to remain in the same property.

One reason the regulatory system has worked so well in Germany is that house prices have fallen in real terms and often in money terms for the last two decades. However since 2007 this position has changed in some major cities. Prices and owner-occupation rates have been rising, and rental markets are beginning to silt up in high-demand areas, with queues for rented properties resulting in people having to bid for dozens of units (including providing significant documentation). There is considerable evidence that new investment is not keeping pace with demand.

## *France*

For many decades in France there was no initial rent control except on rental units built prior to the 1948 Rent Act. A typical lease is for three years and there is a right to negotiate a further lease unless the landlord wishes to use or sell the property or the tenant causes serious problems. Since 2008, annual rent increases have been governed by the Rent Reference Index (IRL), based on the cost-of-living index. The rise in the IRL since 2011 led to a rapid increase of private rents especially in Paris and other major French cities.

The ALUR Act (*l'accès au logement et un urbanisme rénové*), passed in March 2014, allowed for limits on initial rents in 28 high-pressure areas. In these cities, rents on new leases would be limited to 20% above the local median rent as determined by local 'rent observatories'—new bodies set up to collect rent data. In September 2014, after criticism from landlords and investors, the government scaled back the plans and announced that the controls would be introduced experimentally in Paris only. As of April 2015 the government has not yet taken the final legal steps to bring the law into force, but the expectation is that this will happen within the next few months.

The new law also has some benefits for landlords. It caps taxes on rental earnings for properties in shortage areas, and creates a government-run rent insurance fund to which both tenants and landlords must contribute. If a tenant defaults the landlord can apply to the fund for reimbursement.

## *The Netherlands*

The Netherlands has the largest proportion of social housing in Europe at 1/3 of the stock, and many middle-income families live in the sector. Private rental now accounts for only 10%, and its share continues to decline. Much is owned by long-established private companies seeking regular income. Some such owners are now aiming to realise value for their 'pension funds' by selling into owner-occupation.

Social and private rental housing are covered by the same regulations around rent and tenure security. For most rented housing, rents are set via a 'points' system. Points are allocated for

characteristics such as the size, condition and facilities of the home<sup>3</sup>, as well as the characteristics of the local environment (transport, shops, schools etc.)—but not for the desirability of the location. The number of points determines the maximum rent that can be charged. A new tenant has six months in which they may challenge the rent before the Rent Commission.

At the top end of the market—that is, for dwellings with over 142 points, which in 2014 gave a maximum rent of over €700/month regardless of size—rents are decontrolled. This is the case for both social and private rented housing. The number of points necessary to achieve decontrol is revised annually in January. This regime was put in place in 1990 for new construction and in 1994 for existing dwellings, with the goal of gradually freeing rents as the proportion of decontrolled properties grew. The ‘free’ rented sector reached 5% by 2004, and the aim was that 25% would be deregulated in the following five years, but the target was dropped by the new government in 2007. Currently about 30% of private rented dwellings have decontrolled rents (Whitehead *et al* 2012). An annual government decree sets out the permitted increase in regulated rents, which since 2008 has been in line with inflation.

There are a great many rented dwellings with more than 142 points for which the landlords charge less than €700/month—even though they *could* charge as much as they like. The actual rent charged, rather than the number of points, determines whether the letting remains in the regulated sector. This anomaly comes about for two reasons: first, because some local markets in the Netherlands simply will not support higher rents; second, because housing associations are the dominant landlords. Their stock of ‘social’ housing competes directly with private rented housing. Much of it is of high quality and there is little or no stigma associated with living in social housing in the Netherlands. The housing associations see it as part of their social mission to keep rents low; they are also wealthy and do not need to maximise returns. This means that private landlords with properties renting at or somewhat above the cut-off point find it difficult to compete with housing associations as the latter charge much lower rents<sup>4</sup>. This is one reason that institutional landlords in particular have been divesting from the sector.

In some areas, though, market rents are much higher and there are still shortages, since the results of the points system do not necessarily correspond with market outcomes. Particularly in high-demand, high-cost areas, the system produces large gaps between regulated and free-market rents. This has led to the emergence of black markets with side payments and sub-letting by tenants paying regulated rents. To address these issues, in 2011 the system was modified to give extra points to dwellings in ten high-cost areas, so landlords could charge higher rents on new lettings. In these areas, dwellings worth less than €2900/m<sup>2</sup> (according to the national property valuation system) were allocated 15 extra points, while those worth more than €2900/m<sup>2</sup> were allocated an additional 25. This has taken significant numbers of units out of regulation on vacancy. Recently the Dutch government agreed that the €700 limit would be maintained for three years with the intention of incentivising the transfer of properties to the deregulated sector.

In 2013 and 2014, landlords were permitted to impose larger rent increases on high-income households. Those earning more than €43,000 per annum could see rents increase by 6.5%. These higher rent increases were initially coupled with a temporary tax on all landlords owning more than ten dwellings with regulated rents, but the two policies have now been separated.

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3 The main determinant is size—one point is given for each square metre of internal space. Other factors include for example having its own boiler (3 points, or 5 for a condensing boiler), floor insulation 2 points, bath 6 points, etc. (See Fitzsimons 2013 pp 23-26).

4 In 2010 housing associations owned 1.06m dwellings with over 142 points, but on only 87,600 was the rent more than the cut-off (Fitzsimons 2013 p. 96).

Leases are generally indefinite and binding on the new landlord if the property is sold. Tenants can be evicted only if the tenant has not fulfilled his or her obligations, or if the landlord wants to use the property themselves. The period of notice is between three and six months, depending on how long the tenant has lived in the property.

## *San Francisco*

Most San Francisco homes are rented (about 60%, according to the 2010 US Census). San Francisco introduced rent control in 1979 for dwellings in multi-unit properties built before 1979, and since then extended it to pre-1996 tenancies in single-family homes. The regulations cover the majority of the city's rental property. Rent control does not apply to post-1996 tenancies in single-family homes, which includes condominiums (apartments in individual ownership). Thus if a multi-unit building is in single ownership the apartments are rent-controlled, but if the units are individually owned (as is typical in the UK) then rent control does not apply.

There is no restriction on the initial rent on a new lease. Tenancies are de facto indefinite, with the tenancy ending only when the tenant decides to move or the landlord obtains a court order under 15 specified grounds for eviction. Within the lease landlords can only raise the rent by a set amount each year. This amount is determined annually by the San Francisco Rent Board and is meant to be 60% of CPI inflation in the local area. Permitted rent increases have been consistently low; for the year to 28 February 2015 the allowed increase was 1%, and in the preceding 20 years the permitted increase exceeded 2.5% only three times. Because the permitted increase is below inflation, real rents in rent-controlled units fall throughout the tenancy.

Landlords can request permission to increase rents because of increased costs or to pay off investments in capital improvements. In the latter case the rent increase applies only until the investment is paid off (San Francisco Tenants Union 2014). Rent control is also used punitively to enforce housing standards: if an otherwise non-rent-controlled unit has housing code violations that remain uncorrected for 60 days or more, the unit becomes subject to rent control.

Rent control applies to multi-unit buildings in single ownership, which covers much of San Francisco's housing stock. Landlords cannot normally ask tenants to leave without cause, but under California's 1986 'Ellis Act', landlords can evict all the tenants from a building in order to remove it from the rental market. If they do so, they must pay each evicted tenant compensation ranging from \$5,000 to \$16,000. The vacant properties resulting from Ellis Act evictions are normally sold into owner-occupation; if the units are re-rented then for the first five years the rent cannot exceed the rent that the evicted tenant was paying, and the evicted tenant must be given first refusal.

San Francisco has long been one of the country's most expensive residential markets, and the strong Silicon Valley economy has fuelled a post-crisis upturn in prices for owner-occupied housing. Landlords who do sell can potentially make large profits, and in recent years there has been an increase in Ellis Act evictions, as landlords sell to developers. In absolute terms though the numbers are small; there were 216 Ellis Act evictions in 2014, and 309 in the previous year. The press has recently reported that some 'Ellised' buildings are now used for vacation rentals through e.g. VRBO and AirBnB.

Rent levels and the rights and responsibilities of tenants and landlords are long-running local political issues, with vocal and well-funded advocacy groups on both sides. The city has become a popular residential location for well-educated, well-paid Silicon Valley employees who reverse commute. This has generated strong pressures to incentivise low-income/low-rent tenants to leave, and there have recently been protests against the gentrifying effects of 'Google bus' commuters.

## International experience: tax relief

The Labour Party proposed to remove the ‘wear and tear’ allowance from private landlords who did not maintain their furnished properties adequately, while the Green Party advocated the removal of the mortgage-interest deduction for private landlords. The UK already stands out for its relatively unfavourable tax treatment of landlords. This section puts the UK system in context and summarises international practice in this area.

In the UK, the activities of private landlords are treated and taxed as businesses (rather than investments). Landlords, like other business owners, are therefore permitted to deduct those expenditures related to the operation of their business from their business income. In the case of landlords as well as other types of business this includes interest payments on loans (but not repayments of principal). Landlords of fully furnished accommodation are also allowed to deduct 10% of the net rent to cover ‘wear and tear’—essentially a form of depreciation. In practice this allowance is probably only available to a minority of landlords. According to one recent survey, some 30% of landlords let their properties furnished, 8% let them part-furnished and 43% let them unfurnished. The remainder—about 19%—had a mixture of furnished and unfurnished lets (BDRC Continental 2012). The figures from the latest Private Landlords Survey, based on dwellings rather than landlords, were similar: 59% of units were let unfurnished, 15% partly furnished, and 26% fully furnished (DCLG 2010).

In general private landlords are taxed as other businesses and receive no special subsidies. However while those engaged in ‘trade’ are permitted to offset trading losses against income from other sources, landlords can only set losses against rental income in the current year, or carry them forward. The tax rate payable depends on whether the landlord is an individual or a company. Individuals pay income tax at their marginal rate (20, 40 or 45%) while since 1 April 2015 companies pay corporation tax at a flat 20%. Individuals pay tax on capital gains at 18 or 28% after deduction of any available annual tax-free allowance. Companies do not have an annual tax-free allowance but can claim indexation to reduce chargeable gains (Cave 2015).

Britain is not unusual in its tax treatment of mortgage interest—in fact across Europe landlords can deduct these payments from taxable income, Finland being the only exception (Scanlon & Kochan 2011). But in most countries, other elements of the tax code are more favourable to landlords. In particular, many countries permit landlords to depreciate their rental investments (either the entire value or the cost of the building only). This is not permitted in the UK; the wear and tear allowance is conceptually similar but less generous. Similarly, many countries permit so-called ‘negative gearing’, where landlords can offset losses from residential rental properties against income from other sources. Again, this is not a feature of the UK system. Finally, some countries have lower taxes on rental income than on other business income.

Table 6, below, summarises income-tax treatment of landlords in 15 developed countries, including the USA and Australia. The pink cells indicate less-favourable tax treatment than in the UK, while the blue cells show where countries treat landlords more favourably. The table gives a clear indication that the UK income-tax system is already substantially less favourable to landlords than that of many countries, especially in its treatment of depreciation and negative gearing.

Similarly, many countries provide targeted subsidies (low-interest loans or grants) to private landlords. The goal is normally to incentivise new construction (usually for low-income households) or energy-saving modernisation. In the UK some local authorities do provide refurbishment subsidies, but they are not available nationwide. Depending on their specific characteristics, these subsidies and the tax provisions discussed above act as incentives for landlords to invest in the sector, to provide housing of good quality and/or for specific target groups.

**Table 6: Income tax treatment of residential rental income in various countries**

Colour key:

Tax treatment similar to UK	
Landlords treated more favourably than in UK	
Landlords treated less favourably than in UK	

	<i>Mortgage interest deductible</i>	<i>Lower tax on rental income</i>	<i>Costs deductible</i>	<i>Depreciation allowance</i>	<i>Rental losses offset against other types of income</i>
UK	•	*	•	• *** (furnished only)	
Austria	•		•	• accelerated depreciation for low-rent units	
Australia	•		•	• new properties only	•
Belgium	•	•	•	•	
Denmark	•	• institutions only	•		•
Finland		•	•	• for institutions	•
France	• but cannot lead to loss		•		• up to limit
Germany	•		•	•	•
Ireland	• 75%		•	•	
Netherlands	business	•	•	•	•
	non-business		**		
Norway	•	• if renting part of your home or short-term	•		•
Spain	•	•	•		•
Sweden	•		•	•	
Switzerland	•		•	•	•
USA	•		•	•	• with limits

\*Except for 'rent-a-room' allowance

\*\*An imputed return of 4% of net wealth is taxed at a rate of 30%--i.e. effective income tax rate of 1.2% of equity

\*\*\*Wear and tear allowance of 10% of net rent for fully furnished accommodation

Source: From Scanlon & Kochan 2011, Table 4

## Implications of international experience

We can learn some lessons about longer tenancies and rent stabilisation in particular from European experience, while US examples tell us something about the consequences of rent control. This brief review of international practice highlights three things. First, there has been increasing pressure for control on *initial* rents in many cities or countries where only rent *increases* have hitherto been limited. This is in response to rapid increases in rents for new leases often concentrated in particular cities. New regulations have imposed such limits in several German cities and in Paris (soon to be implemented) and are under discussion in Dublin. On the other hand in the Netherlands the government is trying to encourage landlords to increase rents on some of the stock, so as to bring the units out of the regulated sector. This has much to do with the market dominance of Dutch housing associations—which brings us to the second point.

This is that the effects of regulation of the PRS in any particular place are very strongly conditioned by the overall legal, fiscal and cultural environment. The discussions of international examples often focus only on particular provisions—for example, pointing out that Germany, with a very large private rented sector, also has controls on the amount that rents can be increased within a tenancy. But ‘cherry-picked’ comparisons can be misleading, as they often leave out crucial explanatory factors that may not even be directly related to housing policy.

Third, the UK is perhaps unusual in that it is simple and frictionless to transfer a dwelling between owner-occupation and the private rented sector and vice versa, both because there are no planning controls related to tenure of private housing and because of short-term leases. This gives us a flexible and responsive housing sector, and means it is easy to grow the PRS from existing stock when investors perceive benefits. The UK’s experience in more than doubling the size of the PRS over just 20 years is almost without parallel internationally. Equally, however, the sector could shrink very rapidly if the incentives were to change. It is indeed true that there are other countries or cities where private renting houses a larger proportion of households than here, *and* is much more highly regulated. This suggests that there is no necessary contradiction between a large, well-functioning PRS and a high degree of regulation—but it doesn’t tell us *why* it works elsewhere.

In fact, many things set us apart from places where tighter regulation coexists with a bigger rented sector, not just the degree of regulation. First, many have significantly greater barriers to transfer out of the sector—see for example San Francisco where the Ellis Act must be invoked and the sale of PRS dwellings is highly politicised, or Germany where in principle dwellings can transfer between PRS and owner-occupation but where new owners must honour the leases of sitting tenants. Also, most countries that do regulate rents also try to encourage landlords to stay in the sector by providing favourable tax treatment and/or subsidies.

Finally, all changes in regulation which negatively impact on rents and yields and on risk and confidence can be expected to reduce supply and make it more difficult to for new tenants to find the accommodation they want. To the extent that a new system increases certainties around rates of return and terms and conditions it could help to stabilise the market and make it a better investment opportunity. Some of the proposals have some potential in this direction. However as already stressed all systems depend on the specifics of institutional and regulatory arrangements as well as the choices open to landlords and tenants.

## Annex 1: The current regulatory framework in England

*Tenure security:* Default tenancy is Assured Shorthold Tenancy (AST). Normally lasts 6 or 12 months, and landlord has right to possession with two months' notice at the end of the term, or anytime thereafter. If the tenant remains and no new lease is signed, the tenancy becomes a periodic or month-to-month tenancy at the same rent and on the same terms as the AST.

*Rent regulation:* For leases agreed after 1 January 1989 there is no regulation of initial rents or of rent increases within a tenancy. There is some *de facto* regulation of rents where tenants receive housing benefit or local housing allowance, as support is limited to the bottom 30% of the market and there are absolute caps which bite in some areas, notably parts of London.

*Procedure for possession:* For Assured Shorthold Tenancies (most tenancies that commenced from 1997), landlords may use a Section 21 notice at the end of the lease term or anytime thereafter. This gives them the right to possession with two months' written notice, without having to give a reason; it cannot be used in cases where the landlord seeks to recuperate unpaid rent. If the tenant does not leave when required to do so the landlord may seek 'accelerated possession.' The court makes a decision on the basis of papers (no hearing) and can require the tenant to leave within 14 days, which can be extended to a maximum of 42 days in the case of exceptional hardship. If the tenants still do not leave the landlord can apply for a warrant for possession, and bailiffs will evict them. The procedure is much quicker than the time required for a Section 8 eviction (below).

In cases where the landlord is seeking possession for non-payment of rent or anti-social behaviour, a Section 8 notice may be used. This is a court procedure where the landlord must demonstrate that the tenant is in breach of contract. The Housing Act 1988 sets out eight mandatory grounds for eviction and ten discretionary ones.

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