Institutional Rentals – an Expensive Solution to a Non-existent Problem

By: Ira Ernst Diamandi

This paper outlines the cost-benefit analysis of the government policy promoting institutional rentals. The program's costs are estimated from the state – and the public's - perspective and the benefit according to what is gained by the tenants in government-supervised housing units. The costs include the loss of revenue from land sales and from the tax exemptions that are part of the endeavor to encourage the institutional rental market.

The **first chapter** provides the background of the rental market in Israel, and **the second chapter** reviews such markets around the world.

The **third chapter** discusses the institutionalization of the rentals markets, and **the fourth** outlines the true costs of the rental programs.

The **fifth chapter** discusses the broad issues and the **sixth** summarizes the paper.

Summary:

The rentals market in Israel is typified by perfect competition and decentralization. Most rental apartments are privately owned and rented out based on a contractual agreement between landlords and tenants. Landlords are satisfied with low returns on rented properties, which benefits tenants. Recently, however, the State has taken steps to exclude private investors, at the same time as it implemented a policy promoting large, government-supervised and institutionally managed rental projects that includes rent control and the regulation of the contracts between the renting body and the tenants.

Rent control is harmful, artificially keeping rents below their free-market equilibrium price. This is the professional consensus opinion, based on real-life data and extensively recorded in the literature. Neutralizing the pricing mechanism leads to many distortions, among them weakening economic efficiency by changing tenants'

preferences, decreasing housing stock, lowering the supply of rentals, harming mobility in the labor market, generating non-price competition and creating a black market.

The past attempts of several legislative initiatives to promote rent control in Israel failed, mostly because it was understood that rent control has proven to be destructive. Unfortunately, it seems that public pressure on policymakers to "do something" has ultimately won out. The regulatory infrastructure, having recently undergone several shifts and transformations, is bringing rent control in through the back door in the form of managed cluster housing.

The cost of regulating the contractual relationship between the managing body and the tenants, such as the terms for length of lease and maintenance, is far higher than the benefit it generates. A long-term contract is, in fact, a year-long contract that the tenant has the option to extend. Since this option has a price, long-term contracts are more expensive than yearly contracts (which are renewed by mutual agreement). Granting institutional tenants the first option "for free" does not actually annul the costs, it only transfers them to the public. As to housing maintenance by the management company, a Central Bureau of Statistics survey shows that the subject has only marginal weight in most households' preferences.

The institutional rentals market in Israel did not develop organically. Without the incentives the State generously grants to entrepreneurs who build for rent (such as excessively generous tax benefits) the industry is not economically feasible. The construction of housing for sale is more worthwhile to the companies on the ground. The low return on rental apartments, the high costs and the low long term income flow have also kept institutional players away from the rental market. Thus, aside from the risks extant in transforming the rental market into an institutionally supervised market, the regulation of rentals carries heavy direct costs, since the attempt to artificially engineer the rental market leads to extensive loss of state revenue. The benefit that arises from these projects to a small group of renters does not justify the high cost to the general public.

To estimate the loss of state revenue that stems from incentivizing the institutional rental market, a comparison was made between housing construction projects intended for sale and construction projects for long term rentals. In order to draw a reasonable comparison between the two types of construction a shared basis was required, therefore two areas in which large-scale plots of land were marketed in Israel Land Authority and The Apartment for Rent Company tenders were chosen, one for regular construction tenders and one for tenders for construction designated for rentals: the Eshkol neighborhood in Tel Aviv, and the Rova Maaravi [Western Quarter] in Lod. Different aspects were reviewed, such as the rate of competition for the tender, the final land prices paid by the successful bidders and the projected long-term tax revenue of the capitalized value. The benefit of rental projects is the amount of the aggregate price reduction to the supervised housing tenants, also at capitalized value.

The conclusions were unequivocal – the public cost of “introducing” institutional elements into the rentals market is extraordinarily higher than the benefit to a small group of tenants. The immediate significance of such findings is that promoting institutional rentals gives up an enormous amount of revenue from land sales and taxes. In Tel Aviv this loss amounts to more than a million shekels for every housing unit built for rent (either supervised or free). In Lod, the loss stands at 229,000 shekels per housing unit. In contrast, the benefit for tenants is tiny. In Tel Aviv, the aggregate discount for a housing unit is 299,000 shekels; in Lod 58,000 shekels. In other words, the benefit this program manages to generate is 19%-26% of the public cost!

Moreover, the amount of competition in the tenders for institutional rentals is extremely low in comparison to the free tenders, because rental tenders are already aimed at the big businesses in the market, keeping others out of the game.

Another salient point is the element of randomness in allotting public resources by lottery. While other public assistance programs (such as rental payments assistance, direct allowances, the health basket etc.) are granted according to clear tests for the beneficiaries, subsidizing rent by lottery is almost completely random. One household gets lucky and gains a discount on its rent while another doesn’t, in a manner completely unrelated to socioeconomic factors. Even worse, the socioeconomic status of a Tel Aviv household is higher on average than that of a Lod based one; yet still, the Tel Aviv family will receive a subsidy five times higher than the Lod family. Clearly, this program not only does nothing for inequality by any parameter but may even widen disparities.

The general public loses billions of shekels as a result of such harmful institutional rental policy, while the benefit to a small number of tenants is orders of magnitude lower. This raises the question of what the considerations leading to this policy’s promotion were. The decision-making process in all this has not been transparent. This sort of policy promotion circumvents budgeting since it represents a sacrifice of revenue from land sales and taxes and so is not recorded as a cost and not explicit in the State budget. Without such a “budget line”, public discussion on serious matters of the sort that lose the treasury billions remains superficial, opening the door to populistic measures.

It is apparent that the various government programs offered by the government and the bodies charged with housing affairs do not solve any problems but instead create unnecessary uncertainty and shocks in the market. This program, and others of its kind like raising taxes for private investors, are all about new and mostly inefficient redistribution.

Perhaps it is time to start thinking of ways to enlarge the pie. Increasing supply is the best and most challenging solution. This paper does not offer magic formulas but suggests we stop making things worse. “Primum non nocere”: first, do no harm.

Full paper in Hebrew