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An Economic Assessment of Rent Controls: The Ontario Experience

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Abstract

Rent controls have existed in Ontario since 1975. Although controls have undergone numerous changes, the basic approach has remained a modified cost-pass-through system with provision for the elimination of financial loss and for a return of new capital expenditures, and, prior to 1986, an exemption for new construction. This paper analyzes the economic consequences of the first twelve years of controls. The major effects have been to reduce rents on pre-1976 units but to increase rents on newly constructed post-1975 units, to reduce new construction, to accelerate deterioration and conversion of the existing rental stock, to generate a severe rental housing shortage, to create an environment for "key money," to inefficiently and inequitably redistribute income, and to significantly exacerbate government budgetary deficits by reducing tax revenues and inducing increased government housing expenditures.

1. Introduction: A summary of rent controls in Ontario

Rent controls have existed in Ontario since October, 1975, when they were introduced as a temporary measure in the midst of an election campaign. During their existence rent controls have undergone numerous changes, with the most substantive changes occurring in 1986. The basic approach, however, has remained consistent as essentially a cost pass-through system with provisions for the elimination of financial and/or economic loss.[1] Although the empirical evidence presented in this paper pertains to the pre-1986 period, the results and conclusions are also applicable to the current rent control regime.

The central feature of the rent control system in Ontario is that rents may be increased only once in any 12-month period by a percentage not to exceed that set by statute (the statutory increase). The statutory percentage increase was originally set to enable the typical landlord to approximately recover any cost increases. Prior to 1986, if the statutory increase was insufficient to enable a landlord to recover his cost increases a formal rent review hearing was permitted to determine the permitted rent increase. The statutory increase was 8% from July 1975 to October 1977, 6% from October 1977 to August 1985, and 4% from August 1985 to December 1986.

In late 1986 the cost pass-through approach was modified. The statutory increase was tied to inflation by a formula, which generated a 5.2% rent increase for

1987,[2] and the provision for a rent review hearing if the sttutory increase was insufficient for an individual landlord to recover his cost increases was removed. In a world of steady state inflation, the formula generates a statutory increase equal to the inflation rate if inflation is 6%, higher than the inflation rate if inflation is below 6%, and lower than the inflation rate if inflation exceeds 6%.

Initially, all existing rental dwellings in Ontario except government-assisted housing were subject to controls, although new dwellings completed after the controls were introduced and previously non-rented dwellings were exempted from controls for 5 years after they were first rented. In 1979 the exemption for newly constructed dwellings was extended indefinitely and units with rentals in excess of $750 a month were decontrolled. In 1982 controls were reimposed on units with rentals in excess of $750. In 1986 controls were extended to the previously exempt units constructed after 1975, and to units to be constructed in the future.

In addition to the statutory rent increase (or prior to 1986, to the increase set by rent review on account of cost increases), rent increases are permitted to eliminate financial or economic loss[3] and to reflect capital expenditures. Prior to late 1982, if a landlord experienced a financial loss he could seek a rent review hearing to obtain additon rent increases sufficient to eliminate the loss over a three-year period. In late 1982 rent increases associated with a financial loss were reduced to the lesser of the amount sufficient to eliminate the loss over a five-year period or 5% of the gross rent; in 1986 the financial loss increase was set at 5% of the gross rent. In 1986, when controls were imposed on units constructed after 1975, the concept of economic loss was introduced by recognizing rate of return on equity as an economic cost for units constructed after 1975.[4] An additional rent increase was allowed for these units to eliminate the economic loss on a phased in basis.

Capital expenditures are recognized as a reason for an additional rent increase, the increase allowed being the amount necessary to amortize an expenditure over its expected future life at the rate of interest paid on borrowed funds used to finance the expenditure (or the prime first mortgage rate). After 1986, if capital expenditures were used to obtain an additional rent increase, the permitted statutory rent increase was reduced by 1% of the gross rent, which substantially reduced the effective return on capital expenditures.

The major implications of these regulations are as follows:

1. Prior to 1987:
   a. net rents on units constructed prior to 1976 (pre-1976 units) were essentially fixed in nominal terms, which meant that net and gross rents declined in real terms (unless additional rent increases were justified by financial loss or capital expenditures) because permitted rent increases were sufficient only to allow for the passing through of cash flow cost increases.
   b. gross and net rents on units constructed after 1975 (post-1975 units) were uncontrolled.
2. After 1986:
   a. rents on all units were controlled, but allowed to rise more or less at the infla-