Efficient Rental Markets

WHAT GOVERNMENTS CAN DO TO DELIVER TO TENANTS THE HOUSING THEY NEED

BY DAVID SEYMOUR
About the Author

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Executive Summary

- For several years, Regina has been the site of advocacy for a Rental Unit Licensing (RUL) scheme that would require mandatory, periodic inspections of rental properties.
- Advocates of the scheme claim it will be expensive but effective in solving housing problems and, by association, some of the social pathologies in poor neighbourhoods.
- There is no known empirical evidence regarding the success of RUL schemes in the handful of U.S. cities where they were tried.
- Most of the people found advocating for them in the literature that has been cited are employed as administrators of RUL schemes.
- Conventional economics anticipates that because landlords supply rental housing voluntarily, they will react to government-stipulated standards and compliance by either exiting the market or raising prices. With landlords exiting, we should expect tenants to be left with fewer options to the same extent, that they have better options.
- However, there is the possibility that by correcting market failures, government could increase the overall efficiency of the rental market and therefore the standard of housing available in low-income neighbourhoods.
- Conventional economics predicts that landlords and tenants face the problems of asymmetrical information and moral hazard. This is partially confirmed by the public displays of distrust between landlord and tenant representatives.
- Asymmetrical information is a market failure wherein one party to a deal knows more about what they are offering than another. The result is that the party with less information assumes the worst, or worse than they should about the deal they are entering into. In the case of rental deals, both parties have limited information about the reliability of the tenant/landlord and so assume they are taking a bigger risk than they may actually be taking. The result is a ‘missing market’ for people who would like to pursue good rental conduct, and distrust that leads to neglectful behavior. The level of animosity between advocates of RUL and landlord association representatives recently is an indicator of the level of distrust.
- Moral hazard is a market failure where two parties enter a deal where one or both are able to pass the costs of their actions onto the other, but cannot monitor the true behavior of the other party. The result is that both parties attempt to surreptitiously pass the costs onto the other. In rental markets it is difficult for landlords and tenants to know whether problems with a property result from poor maintenance/treatment or genuine maintenance problems. With no other incentives present, both parties will try to ‘do their worst’ so that the other party carries the cost of neglect.

In the world of e-commerce, these market failures were solved by giving traders an electronic profile that consists of feedback from traders in previous deals. This paper contends that a similar solution for the rental market could solve the missing-market problem faced by landlords and tenants, raise the incentives for good conduct on both sides, lower maintenance costs and ultimately improve the standard of housing.
Introduction

The City of Regina Executive Committee was recently asked to consider Rental Unit Licensing. This policy has been adopted in a handful of U.S. jurisdictions. It involves mandatory, periodic inspections of residential properties that are owned by a landlord and rented to a tenant. Currently in Regina, rental unit inspection occurs only when prompted by a tenant complaint. The substantial effect of the proposal, therefore, would be to make inspections automatic.

Advocates of the scheme identified a set of social problems in Regina’s North Central neighbourhood that, in a negative spiral effect, both cause and are caused by poor quality housing. Their contention is that mandatory inspection and repair of rental properties would break this spiral by raising the standard of housing. It is hoped the negative spiral would be replaced by a positive one, where better quality housing would lead to a reduction in other social pathologies and in turn to a reduction in housing damage, which would lead to further improvement in housing quality.

While this theory has considerable appeal, it is worth evaluating in the framework of conventional economics. The history of public policy is littered with well-intentioned initiatives for which the costs have exceeded the benefits and the unintended consequences have created additional problems or even enlarged the problem they were designed to solve.

Unfortunately, this proposal appears to fall into the category of public policy with laudable intentions but little impact on the problem and unintended consequences that will cancel its benefits.

In this paper, we identify the problem we would like to solve, assess RUL against this problem and then present a policy alternative for comparison.

Background

Regina’s North Central neighbourhood has become an unfortunate beacon for social problems. Unemployment, low income, crime, drug abuse and poor housing are highly concentrated, perhaps more so than any other place in Canada.¹ Being named “Canada’s worst neighbourhood” by Maclean’s magazine in 2005 was perhaps the most severe indictment suffered by the area, but it has also steeled the resolve of those who would like to improve its fortunes.

In particular, the North Central Community Association (NCCA) has taken a proactive approach to improving the neighbourhood. It outlined an aspirational vision² for the state of the neighbourhood in 2020, and it is working toward its different aspects in a number of practical ways, including housing policy reform.

“The history of public policy is littered with well-intentioned initiatives for which the costs have exceeded the benefits.”
The NCCA identified some basic facts about housing in North Central that distinguish it from housing elsewhere.³

- The housing is typically older (and, we infer, smaller).⁴
- It is more likely to be rented rather than owned by the resident.
- It is often in a state of poor repair, and this situation is deteriorating.
- The average occupant is younger, and the average house probably has more inhabitants (young families as opposed to couples without children at home).
- There is almost no new construction in the area.
- In spite of inferior housing and generally poorer tenants, average rents are similar to those found elsewhere in Regina.

This last point suggests the housing market in North Central is performing inefficiently. With this in mind, there may be the potential for policy initiatives that would allow the market to function better. Indeed, this is the spirit of the RUL initiative.

### Positive Rights and Duties

Underlying much of the rhetoric around the supply of suitable housing for all people is the belief that residents hold a positive right to some level of housing. Law professor Richard Epstein recently defined positive rights this way: “A positive right is a right against the state to be supplied with some kind of good or service, independent of your ability to pay for it.”⁵

A right to be supplied with something (in this case, housing) regardless of ability to pay means that someone else must deliver the housing if the people in question cannot provide it for themselves. It should be clear that there are two ways for government to ensure this right.

1. The landlord has to provide housing at the level required by the right even though he or she could otherwise gain the consent of the tenant to rent lower quality housing.
2. Some level of government provides additional funding with which the tenant buys the housing.

While the following section examines the first method, the second is outside the scope of this paper. While greater government transfers may well be the solution to poor housing, this subject is covered at length elsewhere. There are various arguments for and against greater government transfers, with those against generally arguing that transfers would dull the incentives for wealth creation, and those in favour claiming that the current level of transfers is inefficient, because it leaves many without the means to participate fully in society. This paper focuses on improving the efficiency of rental housing markets through sound public policy.

To summarize the first option, there is no reason to believe that awarding a positive right in this way would deliver a higher standard of housing. Because landlords enter the housing market voluntarily, they will compensate for any additional quality demands stipulated by governments by either leaving the market or staying and recovering the additional costs from tenants.

### The Economic Fundamentals

While economics is often seen as the study of money, it is more powerful as a tool for studying human behaviour. With a tool kit of assumptions about how people behave, it allows us to predict how they will adapt to different circumstances, including new policy initiatives. Our task here is to analyze the behaviour and incentives of landlords, tenants and regulators and make some predictions about what the outcomes of different policies might be, regardless of their stated intentions.
To fully understand these dynamics, we turn to an examination of the relationship between landlords and tenants.

**What Landlords and Tenants Do for Each Other**

Returning to the first method for delivering the right to housing, that is, making landlords deliver housing to a certain standard regardless of the tenants’ ability to pay, we begin with an assessment of what tasks are involved in providing housing.

1. **Provision** – a house must be either built or purchased.
2. **Financing** – very few people have enough cash at hand to purchase a house, so they must borrow money. Borrowing requires a certain amount of initial savings and the assumption of considerable risk thereafter.
3. **Property taxes** – must be paid to municipal authorities.
4. **Administration and compliance** – utilities, taxes, planning consents must be facilitated.
5. **Maintenance** – keeping the house and grounds serviceable for habitation.
6. **Funding** – providing funds for all of the above.

With these tasks outlined, the relationship between tenants and landlords is really quite simple. In an owner-occupied home, the owner-occupier carries out all six tasks. In a rented home, the landlord takes responsibility for tasks one through five, while the tenant provides the funding so that the landlord can recover the costs of providing, financing, paying taxes, administration and compliance and maintenance.

It should be clear from the list above that landlords deliver a considerable service. If they did not, particularly if they did not fulfill the financing function, people would simply buy their own houses. Importantly, they do this voluntarily and understandably expect some return. In effect, they are exchanging their time, skills and savings for financial gain. They could just as easily do the same thing through a variety of other channels including bank bonds, stock market investment or investing in a business of their own. Alternatively, they could choose consumption over investment and buy something they want immediately. Landlords voluntarily enter the rental market because the combination of time, skills and saving required appear preferable considering the expected return.

Therefore, any increase in the time and money costs arising from tasks one through five will reduce the attraction of participating in the rental market. To maintain a ratio of cost and return that is superior to other activities, they must raise rents. Otherwise, they will not enter the market. Perhaps this is why some call economics the “dismal science.” The trade-offs are tough. There is no way to increase the quality of services through mere legislation.

Landlords will either exit the market or raise prices. If they exit, tenants lose options; if they raise prices, they will simply force tenants into a segment of the market that they could have entered voluntarily but had chosen not to.

However, there remains the possibility smart government action could remove market failures and lead to an overall increase in well-being. That is, make the benefits everyone receives from the rental market add up to more than they do now. In the next section, we investigate market failures in the rental market.

> **Landlords voluntarily enter the rental market because the combination of time, skills and saving required appear preferable considering the expected return.**
Market Failure

Market failure is an economic concept wherein individuals or firms acting in what they see as their own best interest deliver inferior results. While the term “market” suggests that market failure is an artifact of business and commerce, it is actually a behavioural phenomenon that can apply to any human situation, including political decision-making. David Friedman gave a colourful example of a market failure:

It is about 800 years ago, somewhere in Europe, and I am one of a line of several thousand men with spears, on foot, facing north. The reason we are facing that way is that directly ahead is another bunch of men – on horseback with spears – heading south. It is clearly time for me to do a rapid cost-benefit calculation. If we all stand and hold our spears steady, with luck we can break their charge and only some of us will die. If we start running, their horses will run faster. So I should stand.

That is the wrong answer – and the mistake is the shift from ‘me’ to ‘we.’ I do not control the men to left and right of me, I only control me. If everybody else stands and I run, my running has little effect on whether the line breaks. If it does not, I get away unharmed. If it does, at least I will be ahead of everybody else. If, on the other hand, everybody else runs and I stand, I am dead; if I run I have at least a small chance of survival. So whether the rest of the men in the line are going to run or stand, I should run. Everybody in the line makes the same calculation. We all run and most of us die.6

One particular sub-species of market failure is asymmetrical information. We will examine the housing market in view of this failure in the next section.

Asymmetrical Information and Missing Markets

Asymmetrical information occurs when one party in a transaction knows more about what is on offer than the other. The classic textbook example of asymmetrical information is the buffet (all you can eat) restaurant. The restaurant owner knows that different people will eat different amounts, so he or she attempts to set the price for the average customer.

The problem is that the customers know more about their eating habits than the restaurant owner does. They are more likely to come to the restaurant if the price is less than they would spend if they had to pay the cost of what they actually eat. As a result, the restaurant’s customers generally eat more than the average person does, and the restaurant stands to lose money by charging for the amount of food the average person would eat.

Therefore, the restaurant revises its prices upward until it is charging not for the average eater but for the average customer who comes to that restaurant. This is where the concept of the missing market comes in – there is no market for customers who eat a small amount. They would end up paying a lot more than they want to pay, and the balance would subsidize the big eaters. So, they are more likely to go to a restaurant where they can order a set portion for themselves.

After that long introduction to the concept of asymmetrical information and missing markets, we move to a central contention of this paper: There is a double information asymmetry in the rental market, and it results in missing markets for both good tenants and good landlords in poor neighbourhoods.
Landlords, and ultimately their tenants, must pay for maintenance. If a house is in a poor state of repair, then either the tenant bears the cost of living in a poorly maintained house or the landlord must pay to fix it. The maintenance costs can be reduced by a relationship of trust and cooperation between tenants and landlords. If the tenant thinks the landlord is a conscientious maintainer, he or she will be more likely to take good care of the property. In parallel, the landlord will more likely be a conscientious maintainer if he or she thinks the tenant is careful with the property.

The recent skirmish over the introduction of a RUL program to Regina has drawn out the level of distrust between representatives of both tenants and landlords. On the one hand, Jason Hall, the president of the Regina Landlords Association, said, “[The RUL] is just going to create possibly more homeless. (But) these people should be homeless if they’re wrecking houses because they should be in jail.” On the other hand, the entire thrust of the RUL proposal is that landlords are irresponsible and must be disciplined by the power of the state. Rob Deglau, the community co-ordinator for the NCCA said, “The tenants even in the worst-case scenarios have said, “I’m prepared to pay [costs associated with RUL programs.]” Because, you know what, it gives them a place where they don’t have to worry about being evicted and they know government is looking after housing and they feel safer.”

Common sense tells us that neither position can be entirely correct. The first argument is that all tenants are bad and all landlords are undeserving victims of tenants who destroy their properties. The second tells us that when rental houses are in poor repair, it is a result of uncaring landlords who leave their tenants in poor accommodations simply because they are able to. It seems unlikely all landlords are uniformly bad or all tenants are uniformly good. Common sense tells us that the difference between people within any particular group are usually greater than the differences between the groups generally.

A more constructive approach to explaining this environment of distrust is that landlords and tenants with good intentions struggle to identify each other. There is effectively a missing market for good landlords and tenants. Tenants cannot know how conscientious a landlord is, and (as a general assumption) they do not want to expend effort being model tenants if it means that, like small eaters at buffet restaurants, they are simply subsidizing others who take less care of properties. Landlords, for their part, do not want to invest in being model landlords given that they may end up having their efforts rewarded with abused properties and the cross-subsidization of others because they pay larger-than-average costs while others who have better tenants by chance alone lose less to maintenance issues.

Just like the spearmen on the hillside, we have a co-ordination problem in low-end rental markets where everyone acting in his or her own best interests, given the extent to which they can reliably trust others, actually produces an inferior result for all.

This paper contends that solving the co-ordination problem is the best and, in fact, the only thing government can do to deliver a net gain to residents in poor neighbourhoods. However, there is one further market failure: moral hazard.

**Moral Hazard**

Moral hazard occurs when two parties in an agreement have differing goals and cannot reliably monitor each other’s behavior. The classic application of moral hazard is in the insurance industry. Once an article is insured and the insurance company takes the risk of its loss or damage, the owner has a weaker incentive than he or she did previously to look after the asset. Insurance companies usually respond by demanding a deductible, a payment that must be made before a reimbursement for loss or damage is given, and by rewarding careful owners with discounts, sometimes known as a no claims bonus.
The problem with moral hazard is that it is very difficult for the insurer to tell how careful the customer is. Did the customer leave the car unlocked because he or she knew insurance would cover a theft or was that the normal behaviour that the insurer was committed to insuring from the outset? Similarly, there is a moral hazard problem in landlord-tenant relationships. The landlord’s goal is to minimize maintenance expenditures, while the tenant’s goal is to minimize any inconvenience that results from caring for the property, given that the maintenance costs can be passed on to the landlord. Not only do the two parties have differing goals, they cannot monitor each other’s behaviour. Landlords cannot know what level of damage is caused by poor care or what level of natural wear and tear they can expect.

In summary, the lower end of the rental market suffers from two market failures. There is a missing market for good conduct between tenants and landlords, and there is a moral hazard problem once tenant agreements are set. We now move to evaluate RUL against these problems.

The Case For Rental Unit Licensing

The case for RUL was made in the introduction but will be briefly restated here. It means that all rental properties would be subject to mandatory government inspection on a periodic basis. Poor-quality housing would be compulsorily fixed up. This would result in a reduction of health problems, crime, poverty and ultimately home damage, as the standard of housing in the neighbourhoods improved.

Should We Expect It to Solve the Problem?

We have already examined the argument that RUL would help deliver a positive right to a certain level of housing and concluded that because landlords voluntarily offer a service to the market, any stipulation of standards higher than currently offered would cause landlords to leave the market or raise prices. In either case, tenants will not make any net gain. A reduction in the supply of housing would be expected to result in increased homelessness or overcrowding or a reduction in tenants’ spending power for other commodities.

This is broadly the conclusion of the major study cited by Regina-based advocates of RUL: “Milwaukee should not implement RUL because the policy would be very expensive, meet strong political opposition, and cause more problems to the city’s rental markets than it would solve.” This report and the NCCA report largely based upon it both accept that there is no quantitative evidence surrounding the overall affect on housing markets. They do, however, draw on two arguments originating in the Milwaukee report. The first is that in certain circumstances it is politically possible to implement RUL programs. Secondly, a survey of personnel responsible for administrating various RUL programs found that such people believe the programs work.

Suffice to say, history has not found all politically possible policies to be good ones, and the testimony of those with a vested interest in a question should not be relied upon exclusively.

But what of the market-failure arguments? Is it possible that by solving the problems of asymmetrical information and moral hazard, RUL could increase the overall efficiency of the rental market and allow everybody to win? The obvious answer to the asymmetrical information problem is to provide better information. Ditto the moral hazard problem.
RUL would not provide better information for either side of the argument, though in theory it might reduce the need for information on the tenant side by reducing the possible range of behaviors that tenants have to prepare for.

By removing the possibility that landlords will offer housing below a certain level of maintenance, the knowledge gap on the tenants’ side is lessened. However, there are two problems with this approach.

Firstly, there is still a knowledge gap on the side of the landlords who are no wiser as to the nature of potential tenants. Secondly, as already mentioned, there will be a supply reduction as landlords reconsider whether or not they want to be in the market given the new standards stipulated by government.

As to the moral hazard problem, a similar analysis applies. RUL means that housing standards would rise, but this improvement would result in a contraction in the housing supply. Meanwhile, it would not enhance the ability of either party to monitor the behaviour of others. It might reduce the range of behaviours that tenants can expect from landlords, but it would not give landlords any greater ability to monitor the behaviour of tenants.

What Unintended Consequences Might RUL Have?

Landlords participate in the market voluntarily, and any forced reduction in the returns they expect will lead to them using the resources previously devoted to the rental market for other purposes or seeking greater cost recovery from tenants. This kind of consequence was touch upon numerous times by the Milwaukee report, most notably: “A rental unit licensing program could also have substantial impacts on the level of investment in Milwaukee’s housing stock by landlords.”

Identifying an Alternative

It should be clear by now that RUL is an effective strategy for improving the social and economic well-being of anyone. The positive effects are likely to be weak, and the unintended consequences would likely cancel them out. The empirical evidence offered in support of RUL is either non-existent or very weak. To illustrate the inadequacy of RUL as a solution to the problem at hand, another alternative is presented here.

The Lesson from eBay

Online-auction site eBay is one of the greatest Internet success stories of the past decade. It is the focal point for millions of people who wish to buy or sell a variety of goods. It has succeeded for several reasons.

- It increased the speed of publication (instant rather than waiting for a newspaper to be published).
- It increased the effective size of the market as one can browse listings from the entire world. (A printed version would not be economically viable or possible.)
- It has solved the moral hazard and asymmetrical information problems for traders. Traders can build up an online reputation that consists of short reviews from people they have traded with. It is this last feature that we now focus on.

As discussed in the case of tenants and landlords, buyers and sellers on eBay face problems of asymmetrical information and moral hazard. In the course of a transaction, traders must give up possession of their money or their goods and trust that the other will compensate them. Traders thus face a problem of double asymmetrical information. Neither trader knows how reliable the other is. If both assume the other is likely to be of below average honesty, they will be unlikely to fulfill their end of the bargain, because they believe they are unlikely to be compensated. There is effectively a missing market for honest traders.
“Each would be able to evaluate the reliability of the other before entering into a transaction.

The problem can also be framed as one of moral hazard, where once the trade is agreed upon, both parties have an incentive to receive their goods or money while passing the cost on to the other party by not paying or not sending the goods. In the time one is waiting for the other to come through, the parties have opposite incentives and cannot monitor each other’s behaviour.

In theory, eBay should not exist, let alone be the vast success story it is. The high level of trust between traders due to such limited information should be fatal. However, building up a profile of reliable trading makes all traders want to be honest. After each trade, both buyer and seller can rate the honesty and reliability of the other person. Over time, this builds up a profile that tells people how reliable a trader is.

Nobody would trade with someone who had ripped off his or her first three traders; it would be the end of the person’s eBay career. Indeed, the norm is a 99 per cent positive rating. For most people, only genuine misunderstandings create negative feedback.

The suggestion is that a similar scheme would dramatically increase the efficiency of the rental market, and given the inferior housing and high rents in the North Central neighbourhood, it is this efficiency increase that is needed.

By creating a situation wherein landlords and tenants maintain a profile of performance in their roles, the asymmetrical information problem is solved. Each would be able to evaluate the reliability of the other before entering into a transaction. The moral hazard problem is also solved, because the incentive for landlords and tenants would no longer be to pass the costs of poor maintenance or poor care on to one another but to maintain a high-profile ranking.

Not only would such a system remove the problem of a missing market for good conduct by tenants and landlords, it would actually motivate better conduct. Having a sound ranking from previous landlords or tenants would be a valuable asset. It would give landlords and tenants with good reputations access to each other. They might even be prepared to offer each other discounts based on the trust they are able to have based on previous behaviour.

The system could be implemented either online or, if Internet access proved to be scarce, as a more traditional paper system carried out by post.

Is This a Role for Government?

Whatever the merits of the system, there is a question of whether government should be involved in funding it. There is a strong argument that this service constitutes a public good and therefore needs to be delivered by a government. Public goods are non-rivalrous and non-excludable. Non-rivalrous means that one person consuming the benefits of a good has little or no impact on the ability of others to consume it. Non-excludable means that it is impossible to prevent people benefiting from the service even if they refuse to pay for it.

In the case of a service such as the one proposed here, the real benefit is an increased efficiency in the rental housing market and the economic and social benefits that would flow from it. Once these conditions are created, it is impossible to prevent people from benefiting from the reduction in social pathologies in the city, and one person benefiting from them does not prevent another from benefiting.

It is unlikely the private sector would produce such a service, because the benefits are shared by everyone rather than returning to the service provider. Therefore, there is a
case to be made that funding this service is a role for government.

Other possibilities are provision by the charitable sector, which might be able to discount the financial loss of running the service with the goodwill that comes from providing the service.

A private firm might be able to generate advertising revenue from operating the service; it might also be able to charge a fee for participating, although this would make it harder to gain enough participants to make the rankings significant.

Landlords or tenant groups might find they could recover the cost of the service through the now more efficient rental market.

In any case, such a system has not been successful outside of the internal operations of large rental-property conglomerates. With this in mind, some level of government might want to consider the benefits of funding this service.

The Case for Voluntarism

However the service is funded and produced, participation by tenants and landlords should be voluntary. The reason for this is simple. Participation imposes a cost, whether it is time, money or the effect on the reputation of the person involved. Because the system is designed to make people better off, it is necessary that these costs are lower than the benefits that come from participation. If participation is compulsory, people lose the ability to abandon the system when it is not of net benefit to them. In this case, the number of people involved can no longer be used as an indicator of people's satisfaction, and the system may go on to actually harm people.

Conclusion

The RUL proposal is a well-meaning policy that has all the signs of producing negative results. Conventional economic theory suggests it would have negative and unintended consequences, and while there is a lack of empirical evidence to measure the true results of this policy, the only people found to be vouching for it are those paid to administer RUL systems.

It fundamentally fails to solve the problems of asymmetrical information and moral hazard that make the low-end rental market inefficient, given the public display of distrust between tenant- and landlord-advocacy groups.

To illustrate the ineffectiveness of this solution, an idea from the cutting edge of e-commerce was presented.

By offering tenants and landlords the opportunity to maintain reputation profiles that reflect past tenants’ and landlords’ judgments of their behaviour, the incentives for good conduct on the part of all parties would improve.

There is a strong case that the nature of such a service makes it unlikely private markets would fund it, so the government should be involved. However, that is not to say government must be involved; it is still possible the private sector, advocacy groups or charities could be involved in producing this service.

Finally, participation in the service should be voluntary, so that landlords and tenants can reveal their true preference for participation in the service, and therefore its value.
Footnotes

2. ibid. p. 3.
3. op. cit. See pp. 17-22 for a statistical profile of the North Central area.
4. Based on the authors assumption that house sizes have historically increased.
8. ibid.
10. ibid. p. 17.

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