

# LEASEHOLDS – AN ALTERNATIVE TO REGULAR OWNERSHIP TITLES

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## Abstract

*For property law, the system of estates represents the most obvious of many links between past and present. The very word “estate”, drawn from and implying status, signifies the feudal origins of the system. So does the distinction, still current, between freehold and nonfreehold estates- the first referring to normal tenures of feudal times, the second to mere leases.*

*Leaseholds – or nonfreeholds or tenancies- are a part of the larger estates system. Like the freehold estates, leaseholds have roots that run deep into feudal times (hence the notion of a tenant who holds under a landlord). And again like freeholds, leaseholds have been fairly static over the years in term of their formal characteristics. In terms of relations between landlord and tenant, however, there have been regular and significant developments. The most important of these, together with the body of conventional American law in the background, make up the bulk of this paperwork. The article considers the incidents of leaseholds and then concludes with a selective look at the persistent problem of affordable rental housing.*

**Key words:** leaseholds, landlords, rent control, rental housing, government-assisted housing programs

## Introduction

Finding affordable housing of decent quality is a challenge to many Americans, not just, but obviously especially for the poor. The implied warranty of habitability and allied reforms are aimed to improve the situation. But wouldn't landlords in response to the higher costs imposed on them by such measures simply increase the rents they charge, such that housing might be more decent but even less affordable? Could rent control help allay this problem? What about government assisted housing programs? These are large and contentious questions of which the following debates are just a surface scratching.

## Leaseholds – an alternative to regular ownership titles

In 1986 the Chicago City Council enacted a Residential Landlord and Tenant Ordinance which was not a rent control measure, rather it essentially codified the implied warranty of habitability and, beyond that, established new landlord responsibilities and tenant rights in respects described below.

A group of property owners challenged the constitutionality of the ordinance, but the district court denied a motion for a preliminary injunction, concluding that the plaintiff property owners did not have a reasonable likelihood of prevailing on the merits, thus the plaintiffs appealed. The court of appeals affirmed in an opinion by Cudahy J., holding, among other things, that the ordinance was sufficiently specific and, giving due deference to the legislative judgment, sufficiently reasonable in light of its stated purpose to promote public health, safety and welfare. Of interest to us is not the constitutional analysis in Judge Cudahy's opinion but the policy analysis in a separate opinion filed in the case, an opinion has moved Judge Cudahy to say “the economic critique of the Ordinance contained in the separate opinion has not been litigated here and is, at best, superfluous.”<sup>1</sup>

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<sup>1</sup> Chicago Board of Realtors Inc. v. City of Chicago, United States Court of Appeals, Seventh Circuit, 1987, 819 F.2d at 737 n.2.

Posner J. with whom Easterbrook J. joins: "We agree with Judge Cudahy's opinion as far as it goes, and we therefore join it, but in our opinion it does not go far enough because it makes the rejection of the appeal seem easier than it is, by refusing to acknowledge the strong case that can be made for the unreasonableness of the ordinance. So we are led to write separately, and since this separate opinion commands the support of two members of the panel, it is also a majority opinion."<sup>2</sup>

The new ordinance rewrites present and future leases of apartments in Chicago to give tenants more rights than they would have without the ordinance. It requires the payment of interest on security deposits, it requires that those deposits be held in Illinois banks, it allows with some limitations a tenant to withhold rent in an amount reflecting the cost to him of the landlord's violating of term in the lease, it allows a tenant to make minor repairs and subtract the reasonable cost of the repair from his rent, it forbids a landlord to charge a tenant more than 10 dollars a month for late payment of rent regardless of how much is owing and creates a presumption that a landlord who seeks to evict a tenant after the tenant has exercised rights conferred by the ordinance is retaliating against the tenant for the exercise of those rights.

The stated purpose of the ordinance is to promote public health, safety and the quality of housing in Chicago. It is unlikely that this is the real purpose and it is not the likely effect. Forbidding landlords to charge interest at market rates on the late payment of the rent could hardly be thought calculated to improve the health, safety and welfare of Chicagoans or to improve the quality of the housing stock, but it may have the opposite effect. The initial consequence of the rule will be to reduce the resources of the landlords devote to improve the quality of housing, by making the provision of rental housing more costly. Landlords will try to offset the high cost, in terms of time value of money, less predictable cash flow and probably higher rate of default by raising rents. To the extent they succeed, the tenants will be worse off or at best no better off. Landlords will also screen tenants more carefully because the cost of renting to a deadbeat will be higher, so marginal tenants will find it harder to persuade landlords to rent to them. Those who do find apartments but then are slow to pay will be subsidized by responsible tenants who will be paying higher rents, assuming that the landlord cannot determine in advance who is likely to pay rent on time. Insofar as these efforts to offset the ordinance fail, the cost of rental housing will be higher to landlords and therefore less will be supplied, more of the existing stock than would otherwise be the case will be converted to condominiums and cooperatives and less rental houses will be built.

The provisions of the ordinance requiring that the interest on security deposits be paid and that deposits be kept in Illinois banks are as remote as the provisions on late payment from any concern with the health or safety of Chicagoans, the quality of housing in Chicago or the welfare of Chicago as a whole. Their only apparent rationale is to transfer wealth from landlords and out-of-state banks to tenants and local banks making it an unedifying example of class legislation an economic protectionism rolled into one. However, to the extent the ordinance seeks to transfer wealth from landlords to tenants it could readily be undone by a rent increase, the ordinance puts no cap on rents<sup>3</sup>.

The provisions that authorize rent withholding, whether directly or by subtracting repair costs, may seem more closely related to the stated objectives of the ordinance, but the relation is tenuous. The right to withhold rent is not limited to cases of hazardous or unhealthy conditions and any benefits in safer or healthier housing from exercise of right are likely to be offset by the higher costs to landlords, resulting in higher rents and less rental housing.

The ordinance is not in the interest of poor people. As is frequently the case with legislation ostensibly designed to promote the welfare of the poor, the principal beneficiaries will be middle-class people. They will be people who buy rather than rent housing (the conversion of rental to owner

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<sup>2</sup> Chicago Board of Realtors Inc. v. City of Chicago, United States Court of Appeals, Seventh Circuit, 1987, 819 F.2d at 737 n.2.

<sup>3</sup> Coase, The Problem of Social Cost, 3 J. Law & Economy 1, 1960.

housing will reduce the price of the latter by increasing its supply), people willing to pay a higher rental for better-quality housing and a largely overlapping group more affluent tenants who will become more attractive to landlords because such tenants are less likely to be late with the rent or to abuse the right of withholding rent. The losers from the ordinance will be some landlords, some out-of-state banks, the poorest class of tenants and future tenants. The tenants are few in number, the out-of-staters can't vote in Chicago elections, poor people in society don't vote as often as the affluent<sup>4</sup> and future tenants are a diffuse and largely unknown class. In contrast, the beneficiaries of the ordinance are the most influential group in the city's population so the politics of the ordinance are plain enough and they have nothing to do with either improving the allocation of resources to housing or bringing about a more equal distribution of income and wealth<sup>5</sup>.

A growing body of empirical literature dealt with the effects of governmental regulation of the market for rental housing. The regulations that have been studied such as rent control in New York City and Los Angeles are not identical to the new Chicago ordinance, though some regulations which require that rental housing be habitable are close. The significance of this literature is not in proving that the Chicago ordinance was unsound, but in showing that the market for rental housing behaves as economic theory predicts: if the price is artificially depressed or the costs of landlords artificially increased supply falls and many tenants, usually the poor and the newer tenants are hurt<sup>6</sup>. The single proposition in economics from which there is the least dissent among American economists was that "a ceiling on rents reduces the quality and quantity of housing available"<sup>7</sup>.

Posner and Easterbrook pretty much capture the case against rent controls. Virtually all economists, as they point out right at the end of their analysis, regard them as counterproductive. All American economists, that is fewer than 2 percent of them dissented from the proposition stated by Posner and Easterbrook, but almost 44 percent of French economists did, along with almost 20 percent of Swiss economists and 11 percent of Austrian economists, down to 6 percent of German economists.

Defenders of rent control respond to such conclusions in two different ways, arguing either that they are unreliable or largely irrelevant. Finding "little research that systematically examines the differences between restrictive, moderate and strong rent controls in cities across the United States", the authors undertook a "comprehensive review of studies by economists, political scientists, planners and sociologists. Such a review suggests that neither moderate nor strong forms of control have caused a decline in either the quality or supply of rental stock. Although such findings do not, of course, prove that rent controls are without deleterious effect, they provide a warrant for drawing the conventional conclusions"<sup>8</sup>. They add: "Rent control has not, however, brought average rents down to affordable levels"<sup>9</sup>. On the other hand they wonder whether economists have overlooked important non-utilitarian considerations that might trump the conventional analysis and insist on the idea that existing tenants are usually the primary beneficiaries of the most rent controls, but perhaps that's the whole point: "rent controls make it possible for existing tenants to stay where they are, with roughly the same proportion of their income going to rent as they have become used to, a result that might be

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<sup>4</sup> Filer, *An Economic Theory of Voter Turnout* (Ph. D. Thesis Dept. of Economy, University of Chicago, dec. 1977), page 81; *Statistical Abstract of the U.S. 1982-1983*, pages 492-493.

<sup>5</sup> DeCanio, *Rent Control Voting Patterns, Popular Views and Group Interests in Revolving the Housing Crisis* 301, Johnson ed. 1982, pages 311-312.

<sup>6</sup> Olsen, *An Econometric Analysis in Rent Control*, *J. Pol. Econ.* 1081, 1972, page 80; Rydell et al., *The Impact of Rent Control on the Los Angeles Housing Market*, ch. 6, *Rand Corp. N-1747-LA*, 1981; Hirsch, *Habitability Laws and the Welfare of indigent Tenants*, 61 *Rev. Econ. & Stat.* 1981, page 263.

<sup>7</sup> Frey et al., *Consensus and Dissension Among Economists: An Empirical Inquiry*, 74 *Am. Econ. Rev.*, 1984, pages 986, 991.

<sup>8</sup> John I. Gilderbloom & Richard P. Applebaum, *Rethinking Rental Housing*, 1988.

<sup>9</sup> *Reassessing Rent Control: Its Economic Impact in a Gentrifying Housing Market*, 101 *Harv. L. Review*, 1988, page 1835.

justified in some circumstances than in others. From a moral point of view, then, judgments about rent controls must turn very much on context<sup>10</sup>. They might be justified in the easy case where a landlord is earning monopoly rents, for example, but not where the landlord lives on the premises and rents a proportion to commercial tenants or transients who are not maintaining a home<sup>11</sup>.

In respect of government-assisted housing programs, whatever the merits of the debates sketched above, it might be that decent housing is simply beyond the reach of the poor, absent government financial support, but this aid can take a number of forms: project subsidies tied to specific dwellings, in other words, traditional public housing and if the recipient leaves the dwelling, the subsidy is forgone; housing allowances distributed according to need and to be spent for housing only, the money is not tied to dwellings but to recipients which may take the subsidy with them where they move; income maintenance programs involving unrestricted cash payments to needy recipients who may spend the money as they wish. The following paragraphs consider American low-income housing policy in term of alternatives.

There has been a series of questionmarks raised<sup>12</sup>. If, as most analyses agree, the major housing facing low income households today is one of affordability, why do public policymakers treat the difficulties by low income renters as housing problems rather than as problems of income distribution? If the problems faced by these households could be solved by increased income, why not provide low income households with unrestricted income supplements rather than subsidies earmarked for housing expenditure? If the market for housing were free of market imperfections, and the only housing problem of low income households was affordability, elementary welfare economics would indicate that an unrestricted income supplement such as negative income tax would be the most efficient policy. Earmarked subsidies and in-kind redistribution are generally considered to be inefficient, since many households would not, if left to their own choice, spend each additional dollar of income on a dollar's worth of housing consumption. Instead, households would typically choose to spend only a portion of the increased income on housing and the remainder on other consumption items such as food and clothing. By providing low income households with in-kind assistance, the public sector's expenditure presumably results in less overall utility than would an unrestricted transfer payment.

The housing market, however, is not free from market imperfections and artificial constraints on supply. Tying public subsidies to housing is justified in circumstances where they can be utilized efficiently to overcome these market failures and constraints. Although most economists believe that housing markets are generally competitive with a large number of actual and potential consumers and sellers, absent government intervention, the housing market may fail to generate an optimal amount of housing. The supply of housing, although quite elastic in the long run, is relatively inelastic in the short run because of the length of time required for site selection, financing and construction. In addition, government regulation impedes the supply of housing, especially for low income households. Zoning and land use regulations, health and safety ordinances, as well as rent control and security of tenure laws, may restrict the supply of housing. Furthermore, discrimination against minorities in the housing market might limit their ability to purchase housing in certain neighborhoods.

Public intervention in the housing market may also be justified by the problem of substandard housing. Deteriorated housing sometimes poses an externality problem. The existence of dilapidated structures may reduce the value of neighboring homes and may lead to disinvestment in the

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<sup>10</sup> Margaret J. Radin, *Residential Rent Control*, 15 *Phil. & Pub Affairs*, 1986, pages 350-353.

<sup>11</sup> Mark Kelman, *On Democracy-Bashing: A skeptical Look at the Theoretical and Empirical Practice of the Public Choice Movement*, 74 *Va. L. Rev.* 1988, pages 199, 271-273; William H. Simon, *Social-Republican Property*, 38 *UCLA L. Rev.* 1991, pages 1355, 1361.

<sup>12</sup> Michael H. Schill, *Privatizing Federal Low Income Housing Assistance: The Case of Public Housing*, 75 *Cornell L. Rev.* 1990, pages 878, 890-900, 948.

neighborhood. Because the owner of the deteriorated structures does not have to bear all the costs generated by his or her property, public intervention such as slum clearance or renovation assistance might be appropriate. In much the same way that a deteriorated building might be considered a negative externality, a high quality building might be a positive externality or public good. The existence of such a structure might increase values and confidence in the community. Private entrepreneurs might avoid making the investment since they would receive only a portion of its benefits, with nearby owners free-riding on the remainder.

Another justification for government intervention in the housing market, as opposed to pure income assistance, is based on noneconomic factors. Although Americans typically accept inequality in most aspects of life, there is a rough consensus that "certain specific scarce commodities should be distributed less unequally than the ability to pay for them."<sup>13</sup> Society may be justified in preferring a minimum entitlement to housing, despite the desires of the recipient, for several reasons. People who prefer other goods and services to a minimum level of shelter may lack sufficient information or be unable to assess rationally the true worth of decent housing, thereby justifying social paternalism. Furthermore, in light of the increasing children born to unmarried, teenage parents, efforts to provide a minimum level of housing consumption may be justified as necessary to protect those who do not themselves have the power to make expenditure decisions. In addition, the knowledge that people are not living in desperately deteriorated and unhealthful accommodations may itself bring taxpayers positive utility and therefore serve as a consumption item for the donors rather than the donees.

The argument that government programs to provide housing assistance to low income households are justified on market failure, supply constraints or societal consensus does not lead to a simple answer to the question of how that assistance should be designed. Typically, housing policies are characterized as either supply or demand oriented. Programs in which the government supports the construction of new dwellings, either by building it itself or by subsidizing developers, are enacted to directly increase the supply of housing. Programs that provide the recipients of assistance with the funds to purchase housing services increase the demand for housing, and indirectly, its supply.

In the following paragraphs it will be dealt with a comparison between public housing, a supply oriented program, and houses certificates and allowances, a demand orientated subsidy.

Since the mid-1930s, the federal government has funded the construction of housing for low-income households. New Deal agencies such as Public Works Administration bought land, cleared slums and built almost 22,000 housing units. Direct federal provisions of housing was initially dealt a blow in 1935 when a federal appeals court upheld a lower court ruling that the federal government could not use its power of eminent domain to condemn sites for housing projects because housing was not a public purpose. In 1937, however, Congress passed the Wagner-Steagall Housing Act, establishing the public housing program. Under the Act, public housing would be built by local public housing authorities rather than by the federal government. In addition to the concern of comity, the program utilized public housing authorities because several state courts had held that cities and states had the power to condemn property for housing. Under the program, a public housing authority and the federal government execute an annual contribution contract which sets forth the parties' rights and obligations. The public housing authority funds the purchase of land and construction of housing by issuing long term bonds, typically with a forty year maturity. The federal government undertakes an obligation to make all debt service payments on bonds, effectively subsidizing all capital costs. The public housing authority, in turn, obligates itself to operate the public housing in a manner consistent with federal statutes and regulations during the term of the annual contributions contract. The municipality in which the project is located is required to grant an exemption from real property taxes for housing development. Unlike housing built by Public Works

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<sup>13</sup> James Tobin, *On Limiting the Domain of Inequality*, 13 *J.L. & Econ.*, 1970, pages 263-264.

Administration, public housing was, from the start, limited to low income households. Due to the onset of World War II, only a modest number of units were built under the 1937 Housing act. In 1949, however, Congress passed another housing act which provided federal subsidies for slum clearance and urban redevelopment. As part of the act, Congress authorized the construction of an additional 810,000 public housing units and established the national housing policy of a decent home and a suitable living environment for every American family. It was not until 1972 that all the housing units authorized by the 1949 Act were actually completed. Today, approximately 1.3 million units of public housing exist in the United States.

From its inception, public housing was controversial. In the 1930s, the private real estate lobby alleged that the program was socialistic and wasteful. Projects were frequently segregated by race and built in less desirable neighborhoods where their presence would not be offensive to community residents. Public housing was originally created for temporary occupancy by the submerged middle class. As soon as residents could get themselves on their feet, they were expected to move elsewhere. During the 1950s, however, the socioeconomic character of public housing changed. Federal government policies and programs such as mortgage insurance, tax preferences for homeownership and highway construction subsidized the movement of middle and moderate income households out of the city to the suburbs. At roughly the same time, black migration from the south to northern cities accelerated. As manufacturing jobs followed the migration of household to suburban locations, central cities increasingly became home to low income and black households. Public housing no longer served as a temporary haven for upwardly mobile households, but instead became a permanent home to very poor and disproportionately nonwhite population.

As the income of public housing residents plummeted and the age of public housing projects increased, the rents charged by the public housing authorities to cover operating expenses became increasingly burdensome. In 1969, Congress's action to assist tenants by limiting maximum rents chargeable further added to public housing authorities burdens. The federal government enacted subsidy programs to help the authorities pay for operating and modernization expenses. Neither of these subsidies, however, was fully funded, and many public housing authorities further cut back on maintenance which led to structural deterioration and, in some extreme cases, the demolition of uninhabitable buildings.

Public housing is only one of the several housing programs enacted by the federal government to assist low income households. Since the 1970s the government has increasingly relied on the private sector to deliver housing assistance. Although future federal housing assistance for low income households should rely to a greater extent on the private sector for delivery of services, that does not mean that the federal government should cut back its role in financing such assistance or abandon its already sizable investment in public housing. To the contrary, there remains a need for the public sector to assist low income households in obtaining adequate and affordable housing. By using the private sector to deliver these housing services, it is likely that the greatest number of households can be assisted for a given level of federal expenditure. There will remain for the foreseeable future, however, a role in American housing policy for publicly owned rental housing, especially in those circumstances where artificial constraints on supply or housing discrimination exist.

### Conclusions

As a general rule, residential rent regulation makes economic sense if, and only if, two conditions occur simultaneously in the market and are both expected to last for some time. Demand for rental units must rise sharply at the same time that new construction of such units has been legally restricted in order to conserve resources. In the absence of these conditions, rent controls are neither an appropriate nor an effective response to perceived housing shortages, on the contrary they generally exacerbate such shortages.

As a general rule, the more an ordinance intrudes upon the market conditions that would otherwise prevail, the more likely it is to cause dislocations in a housing market. Controversially, less intrusive rent regulations appear to cause less severe dislocations.

Much evidence indicates that all rent controls, even temperate controls, transfer income from owners to tenants or between various classes of tenants. In addition, many of the short-term benefits of rent controls as affluent rather than poor households and some of the costs must be borne by very poor households. Where rent is eliminated as a basis for distinguishing among potential tenants, owners often use other factors such as credit-worthiness, race, sex or ethnicity in allocating scarce rental units, even though most such discrimination is illegal.

On the other hand, the defenders of rent control argue that the conclusions of the economists about rent controls have little application to gentrifying markets and that they will not lead to abandonment, conversion, inadequate maintenance or a decrease in future construction, but will reduce the social costs of poverty by increasing the supply of low-income housing.

I contend that in the future, the public sector should primarily subsidize demand, leaving the construction of additional housing to the private sector. Nevertheless, construction of public housing may be desirable under certain market conditions, including those markets subject to artificial entry barriers and discrimination.

Since many Romanians are in the same boat as the Americans and plead a saving policy to make their lives and their children's future more hospitable, this case study's purpose was to underline the rollercoaster of economic effects that the Romanian housing market would undergo and that we should learn from other's mistakes, having in mind that our economic treasury doesn't even compare to that of the American people, and even so the aid program that they developed wasn't crowned with all that much glory as it was expected, so the Romanian experts should find a way to overcome the necessities of the poor population that cannot rent of the free market, but it should be one that wouldn't kick us, the others, out of house and home, due to the fact that we would have to support the subsidies that the poor would receive.

In the end, the remaining question is if the Constitution should be read or amended to guarantee each individual a right to some minimum level of housing. This is for us to determine and for our children to implement.

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