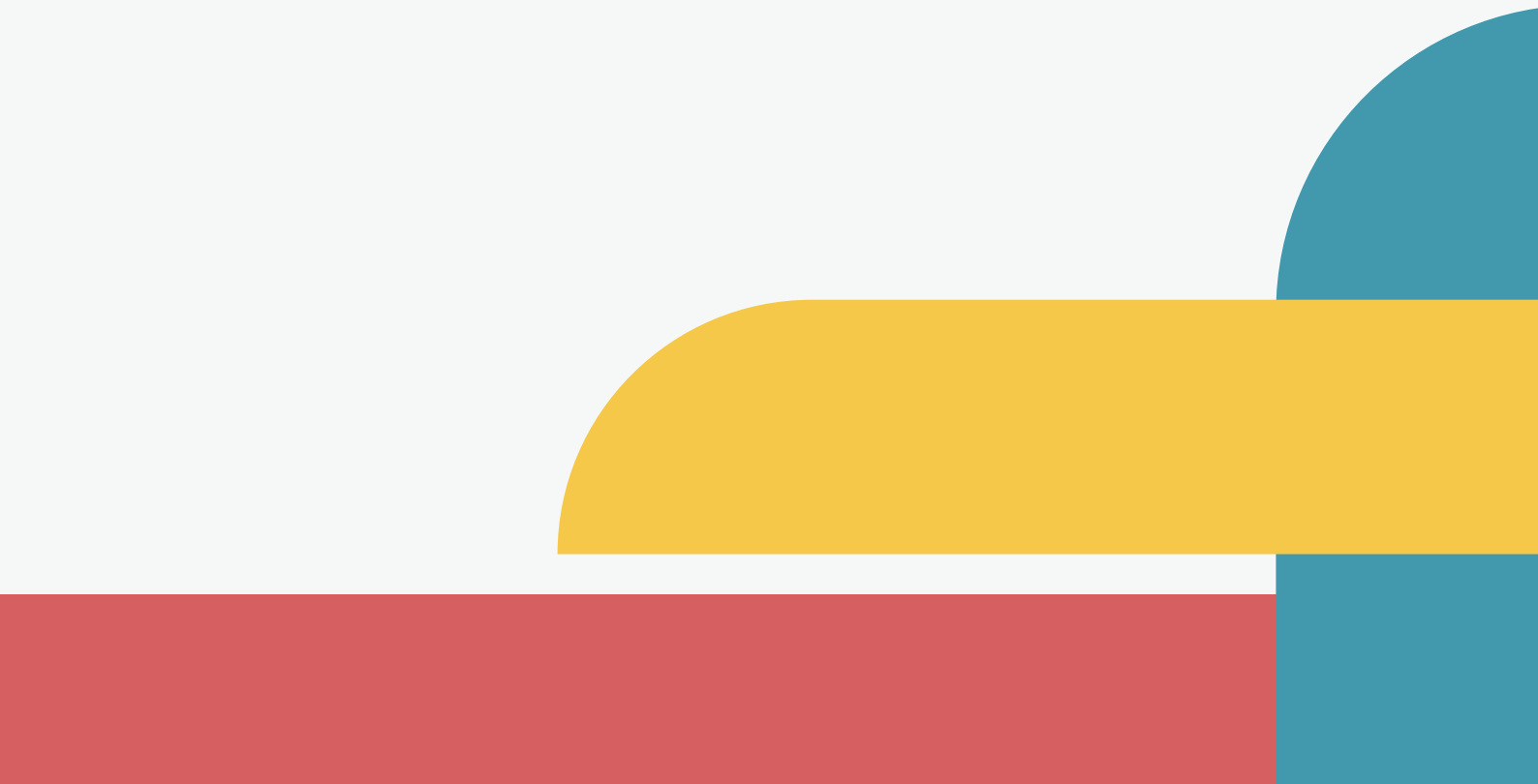




GOVERNMENT OF MALTA
MINISTRY FOR SOCIAL
ACCOMMODATION



The Annual Malta Residential Rental Study First Edition



The Annual Malta Residential Rental Study

(First Edition)





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GLOSSARY

FOREWORD A Return to Regulation in the Maltese Private Rental Market	6
Hon. Minister Roderick Galdes – Minister for Social Accommodation	
FOREWORD Regulation as a friend, not an enemy of the market	8
Leonid McKay, Chief Executive Officer – Housing Authority	
CHAPTER 1 Background on the Private Rental Market in Malta	13
(Author: Dr . Brian Micallef)	
CHAPTER 2 An Analysis of Private Residential Leases Registered with the Housing Authority in 2020	21
(Authors: Mr. Nathaniel Debono, Mr. Reuben Ellul and Dr. Brian Micallef)	
CHAPTER 3 A Framework to Assess Developments in Registered Rents	37
(Authors: Dr. Brian Micallef, Mr. Nathaniel Debono and Mr. Reuben Ellul)	
CHAPTER 4 Housing Authority Survey on the Impact of COVID-19 on Private Residential Leases	44
(Author: Dr Stefan Cutajar)	
CHAPTER 5 The impact of the 2020 Private Residential Leases Act – Insights from Economics	65
(Author: Dr. Marie Briguglio)	
CHAPTER 6 Leases Granted Legislative Protection in Malta: Past developments and Future Implications	76
(Author: Mr. Jean Paul Fiott)	
CHAPTER 7 The First Year of the Private Residential Leases Act: An Assessment Going Forward	94
(Author: Dr. Kurt Xerri)	

CHAPTER 5

THE IMPACT OF THE 2020 PRIVATE RESIDENTIAL LEASES ACT - INSIGHTS FROM ECONOMICS

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Abstract

This chapter applies insights from economics to assess the potential impact of the regulatory regime introduced in the residential leases market, in Malta, as of January 2020. It provides an overview of the main tenets of the Private Residential Leases Act as well as the context in which it was introduced. The chapter outlines the economic case for cautious intervention, highlighting examples of both market and regulatory failure. The analysis draws upon insights from economic theory and hypothesises that such intervention is likely to result in market regularisation and stability, but also higher costs on suppliers (landlords), creating upward pressures on rents. A theoretical exposition of the effects of the Covid-19 pandemic, on the other hand, forecasts a concurrent downward pressure on rents. Insights from administrative data illustrate these arguments in the first year of the new regulatory regime in Malta. The chapter provides practical suggestions for maximising the benefits of regulation while addressing any unnecessary rigidities and deadweight costs. An agenda for further economic research concludes.

Key words: rent; intervention; stability; cost; economics; unintended consequences

1. Introduction: The case for cautious intervention

While most economists agree that some regulation of any free market is, in principle, a necessary thing, they often do so for different reasons. Some focus on the need to reign in excessive market power, others on the need to reduce inefficiencies and frictions, others on the need to provide merit goods or address inequalities⁵². Many would agree that leaving the rental market entirely unregulated, in Malta or elsewhere, is unlikely to be the right strategy to reach the complex objectives of client/tenant satisfaction, entrepreneurial profits as well as economic stability, efficient use of resources, social justice and wellbeing.

⁵¹ Dr. Marie Briguglio, PhD is an economist. The views expressed here represent those of the author and should not be interpreted as representing those of the Housing Authority. Helpful comments by Kurt Xerri, Brian Micallef, Nathaniel Debono and Reuben Ellul are gratefully acknowledged. Any remaining errors are the author's own.

⁵² See Barr, N. (2020), Economics of the welfare state. USA: Oxford University Press.

But economists also tend to also be very sensitive to the design of intervention and to the prospect that government intervention creates unintended and harmful consequences. Simply put, just as markets fail, so too do regulations - be it by omission or by untested, inefficient or overzealous commission. Economists are particularly wary of regulatory failure in rental markets - a subject which has received considerable attention in Europe and elsewhere. While regulation can take the shape of eviction control, quality control and price control, it is the latter which generally garners most concern⁵³.

We need not go too far to see evidence of negative consequences of such regulation in Malta's rental market itself. There is now a general consensus that the rent regimes that preceded the 1995 reform, well-intentioned as they may have been to protect tenants, resulted in considerable decay of rights among property owners and a consequent contraction of the rental market itself.⁵⁴ By Malta Census data, the rental sector shrunk from over three-quarters of the housing market in 1948 to less than a quarter in 2011. The negative effects of this were not limited to loss of income for landlords, but spilled over onto prospective tenants, whose options became more limited. For those who could not afford to buy, prolonged habitation with parents or a long wait for social housing were the remaining prospects. Broader economic effects could also be felt: property owners preferred to relinquish rents rather than risk losing their property rights and housing vacancy rates rose. Reversing these laws will now cost tax payers millions of euro as government juggles the need to respect property owners' rights with those endowed to tenants by the old rental laws. That experience provided regulators in Malta with fair warning to exercise caution in regulating the rental market. By 2020, the rental market in Malta had been almost completely deregulated⁵⁵.

⁵³ In a 2009 review of the economic literature, Blair Jenkins argues the economics profession has reached a rare consensus: that rent controls creates many more problems than it solves, in Jenkins, B. (2009), 'Rent Control: Do Economists Agree?', *Econ Journal Watch*, 6(1).

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⁵⁵ See Xerri, K. (2018), *Renting immovables in twenty-first century Malta*. Malta: BDL Publishing.

2. The new Private Residential Leases Act: Context and content

The new Private Residential Leases Act was contemplated in this context of sparse regulation and abundant economic activity. Save for those still protected by the pre-1995 regulations, rents were rapidly rising, compensating for years of stagnation and propelled by a rapidly expanding demand for rental housing. This demand, in turn, was partly fueled by a policy of attracting foreign workers to Malta and partly by socio-demographic changes in the Maltese population itself.⁵⁶ Rising rents, in the context of fairly stable and low median salaries and low interest rates also attracted more investors into the rental housing market, including Maltese households who saw “buy-to-let” investment as a means of supplementing present income and future pensions.⁵⁷ The new supply, in turn, meant that rents were starting to stabilise finding a natural equilibrium.⁵⁸ In short, market forces seemed to be working.

Yet as the rent:salary ratio rose, affordability concerns had started to feature with increasing regularity on the Maltese policy agenda - including fears of harming Malta’s attractiveness to foreigners. Although little data was available about the rental market, it was generally understood that foreign workers, constituted the vast proportion of the rental market in Malta⁵⁹. The number of Maltese people living in rental properties (which did not form part of the pre-1995 regime) constituted a very small fraction of the residential leases market and of the Maltese population in general. But they were likely to be a vulnerable fraction who were not served by social housing. To protect them from price-hikes, eviction and instability, urgent action needed to be taken. Since its inception as a White Paper, it was quite clear that this demographic was also an important target of the new Private Residential Leases Act.

To reach the goals of stability and professionalisation of the sector, the Act introduced controls

⁵⁶ See Micallef, B. and Debono, N. (2020), ‘The rental sector and the housing block in STREAM’, Central Bank of Malta Working Paper, WP03/2020.

⁵⁷ See Micallef, B. (2018), ‘Constructing an index to examine house price misalignment with fundamentals in Malta’, International Journal of Housing Markets and Analysis, 11(2), p315-334.

⁵⁸ See Ellul, R. (2020), ‘Long-term housing rentals in Malta: A look at advertised listings’, Central Bank of Malta Policy Note [online]. Available at: <https://www.centralbankmalta.org/policy-notes-2020> (Accessed 19 March 2021).

⁵⁹ As discussed elsewhere in this publication, the last census data available was for 2011, subsequent to which the demographic realities in Malta changed substantially

on various aspects of the lease. In a nutshell, it introduced basic regulation (the lease had to be made in writing and duly registered), non-trivial fines (on the lessor) and vested new enforcement rights in the Housing Authority (including the right to enter a property), including swifter procedures through an Adjudicating Panel (for damages up to €5,000). It also forbade certain clauses which previously restricted tenants' rights within the rented property and regulated the eviction process.

More controversially, it introduced a ceiling on the rates of increase of the rents (a kind of "second-generation" rent control) for long let contracts that last over the minimum duration of a year. It also stipulated the exact duration and criteria for short leases and the minimum duration of long leases - although tenants were given the flexibility to leave the contract at no penalty after the 'di fermo' period (6 months in the case of a 1-year contract). In this regard, the law also introduced a friction to discourage termination: fixed term leases would automatically renew unless landlords notified otherwise through registered letters.

3. Analysis of socio-economic impact

Impact of rent regulation - insights from economic theory

The impacts of this kind of regulation can be foretold with the help of economic theory. In the first place, mandatory registration of contracts (and penalties) naturally creates an incentive to register the lease, to abide by the conditions in the regulations, and to declare tax. Even among landlords with minimal preference to conform, the risk of penalty exerts weight in favour of compliance. Moreover, lower uncertainty and swift judicial proceedings benefit both the tenants and landlords, reducing transaction costs to both. Tenants have additional benefits - thanks to the act, they enjoy a wider range of rights, freedoms and a greater security and price-stability for the duration of the contract. As a bonus for the state, the process generates taxes and data. This, in turn, provides funds for intervention and the evidence needed to inform it.

As a direct effect various conditions imposed, lessors are also faced with higher net costs, which in turn, create a general upward pressure on rents. The most obvious increase in costs (to the tune of 15%), is the obligation to declare income if they previously did not. But this is not the only pressure. The cap on the rate of increase of rents also induces landlords to establish a high initial rent as a baseline. Pressures also arise from the uncertainty about the duration of the let itself

and hence the period over which to amortise agency fees and overheads. Similar considerations arise with the exclusion of clauses which give comfort to the investor. Such clauses may have acted as a substitute for higher rents and their removal leaves landlords with few options other than to try to raise the rent.

Aside from these direct pressures on rents, the regulation may also create indirect upward pressures in the longer term, if it suppresses supply of property for long lets. If property owners (or potential owners) perceive the laws as reducing return on investment, then they may divert their assets out of the residential market and into others - such as tourism or commercial (neither of which are regulated by the Act). They may also sell their property and re-invest their capital. Some may simply wait and retain the asset vacant for longer periods - a reaction akin to that which characterised the response to the previous rent regime. The extent of diversion (and the resulting upward pressure on rents) responds not just on the conditions of the residential rental market but also on those present in alternative markets⁶⁰.

The theoretical predictions outlined above may therefore be summarised as follows: the new regulations protect the tenant from unpredictable eviction and price-spikes, professionalise and stabilise the market, but they may also induce landlords to pass costs onto the next tenants and potentially withdraw supply. These predictions are certainly not unique to Malta. Krugman argues that rent control typically inhibits supply and pushes up rents in uncontrolled units⁶¹. A 2019 Stanford study found that rent control benefited the covered tenants but reduced rental housing supply and caused widespread rent increases overall⁶². A Forbes review of the literature reiterates that the positive goals of rent regulation, including security for tenants and enhanced economic and social diversity in urban settings, need to be weighed against the negative consequences, namely those of lower supply and higher rents overall⁶³.

⁶⁰ See Whitehead, C., Monk, S., Scanlon, K., Markkanen, S., & Tang, C., (2012) 'The private rented sector in the new century - a comparative approach' [online]. Available at: <https://www.lse.ac.uk/business-and-consultancy/consulting/assets/documents/The-private-rented-sector-in-the-new-century.pdf> (Accessed 19 March 2021)

⁶¹ See Krugman, P. (2000) 'Reckonings: A Rent affair' New York Times, 7 June, [online]. Available at: <https://www.nytimes.com/2000/06/07/opinion/reckonings-a-rent-affair.html> (Accessed 19 March 2021).

⁶² See Diamond, R., McQuade, T. and Qian, F. (2019), 'The effects of rent control expansion on tenants, landlords, and inequality: Evidence from San Francisco', *American Economic Review*, 109(9), p3365-3394.

⁶³ Miller, N. (2018), 'Rent Control: What It Means For The Real Estate Marketplace', Forbes Real Estate Council [online]. Available at: <https://www.forbes.com/sites/forbesrealestatecouncil/2018/05/31/rent-control-what-it-means-for-the-real-estate->

That rents should rise to reflect the costs necessary to professionalise the sector, ensure decency in service and the payment of taxes is not where the contestation lies. That rents may need to rise further to guarantee meritorious stability can also be justified. The problems arise in imposing so called “deadweight” costs and rigidities which cause unnecessary upward pressures on rents and discourage supply. It is for this reason that, over the past three decades, residential rent regulation has been eased across much of Europe and rendered more flexible juggling the dual goals of stability and responsiveness to market pressures.⁶⁴

The impact of concurrent phenomena

Beyond the effects of regulation, necessary or deadweight, direct or indirect, rents, in Malta and elsewhere, are subject to the other forces of demand and supply. For this reason, the observed outcome, regardless of the costs triggered by regulation may still be stable or indeed declining rents. For instance, rents respond to the supply of rental stock on the market: the greater the supply the lower the rents. Supply, in turn, responds to market conditions, even if with some time-lag. As mentioned earlier, buoyant rents had attracted the building of more stock and this, itself, was starting to suppress rents.

Rents also respond to demographics and social preferences. They respond to the cost of purchasing a dwelling, to the costs of related goods, like utility billing, and several other phenomena. The events that unfolded around Covid-19, which struck the market at around the same time as the introduction of the new regulation in Malta are likely to have created a considerable downward pressure on rents for a number of reasons. Firstly, as incomes declined and job losses occurred, a number of foreign workers were left with little option but to leave. Maltese people in long-lets who experienced income losses may also have switched to lower cost options like flat-sharing or returning to their parental home. As tourism declined, it is likely that property owners switched their offer from tourism to residential. This new supply, added to the rising building stock is also likely to have caused a downward pressure on residential rents.⁶⁵

marketplace/#1bab55147670 (Accessed 19 March 2021).

⁶⁴ Ibid.

⁶⁵ Galea Debono, F. (2020), ‘Short lets have flooded the rental market, pushing prices down’, Times of Malta, 18 May, [online].

Insights from Administrative data

The administrative data that emerges from the first year of data in Malta does not, at face value, contradict these expectations. Firstly, it is clear that mandatory registration did, in fact, create the incentive to register leases (in more than 30,000 instances). Both the risk of penalty as well as landlord/tenant preferences to participate in a regulated market are likely to have accounted for this. While it is not yet possible to accurately quantify this as a percentage of all leases that should have been registered, the Housing Authority considers it to be a substantial turnout for the first year and one that exceeded their predictions. However, a closer inspection of these registered leases reveals that over four-fifths (83%) were signed with foreign tenants - arguably a reflection of the short duration-high turnover of leases among foreigners, and the strong incentive to do so among tenants needing residence documents⁶⁶. The remaining number of registrations attributable to Maltese tenants is low relative to the estimated number of active rentals⁶⁷. In turn, this is, in a large part, due to such rentals being covered by a different regulatory regime. The remaining shortfall may arguably be due to active resistance to regularize one's rental status or perhaps to a more passive failure to understand that this law applies to old contracts too.

Secondly, while it is not yet possible to identify the net effect of the regulation on costs, it appears from Housing Authority data that the first quarter of 2020 registered a significant increase in rents, each month⁶⁸. Prior to the introduction of the Act, rents were reported as having started to stabilise in response to new stock becoming available. Juxtaposed against this backdrop, the increase in rents during January, February and March may be an indication that rents in Malta behaved in line with theoretical predictions.

Available at: <https://timesofmalta.com/articles/view/short-lets-flood-market-pushing-rent-prices-down.792791> (Accessed 19 March 2021).

⁶⁶ The enforcement of the Residential Leases Act was bolstered by a parallel requirement whereby those needing residence documents would need to provide evidence of an address mentioned in a registered rental contract.

⁶⁷ In 2018, the NSO estimated that 30,690 households were paying rent in Malta. However this figure is unlikely to capture the reality of foreigners residing in Malta. The forthcoming census is expected to provide a clearer picture. See National Statistics Office, 2019 'News Release 04 Sept 2019'. Available at https://nso.gov.mt/en/News_Releases/View_by_Unit/Unit_C1/Living_Conditions_and_Culture_Statistics/Documents/2019/News2019_143.pdf (Accessed 19 March 2021).

⁶⁸ This emerges from the analysis of rents in the Hedonic Model presented elsewhere in this publication. Controlling for the effects of type of lease, the monthly effects in the first three months are positive and significant

Thirdly, there are indications that Covid-19 pressures were strong enough to not only dampen any upward pressures on rents by the new Act, but to cancel them out entirely, and indeed, reverse them. This is evidenced both in the survey data collected by the Housing Authority as well as in the analysis of month-on-month changes in rents documented in the register. The latter indicates that the dip started to occur in April 2020 - within a month of the Covid-19 outbreak in Malta. In the regard, it is unlikely that the effects of the pandemic will be ironed out in the short term. While this is good news for tenants, property owners will have experienced two pressures: increasing costs and declining demand.

Fourthly, there are also indications that certain restrictions may have imposed a deadweight cost - which can now be addressed. Mandating maximum/minimum durations for instance, may have created an inefficiency which prevented both parties from reaching agreement on their mutually preferred choice. The asymmetric application of termination clauses may also have created unnecessary uncertainty. The data indicates that a considerable portion of rents were terminated by tenants before the 1-year period, suggesting also that there may indeed be a demand for long-term contracts that last anywhere between 6 months and 1 year. The cap on the rate of increase of rents may also have discouraged landlords from committing to terms longer than the minimum one year - for it is only through fresh contracts that a higher rent can be earned. Here again, the data indicates that long-let contracts overwhelmingly settled for the minimum 1-year duration.

On a more administrative level, the automatic renewal of contracts beyond their term also necessitated that thousands of registered letters be sent and processed in the first year alone - only to re-affirm a legal termination date already agreed to by both parties. Administrative data further suggests that in cases where such letters failed to be sent and the contract was left to automatically renew, considerable uncertainty followed among both tenants and landlords. Insights from Housing Authority administrative data further suggest that difficulties with the mandatory inventory were among the most common cause of a stalled registration process. The short period within which a contract must be registered (10 days) was another unnecessary burden and one which can easily be relieved.

4. Conclusion and agenda for further research

Synthesis

Against the backdrop of this analysis, one may conclude that, from a socio-economic perspective, the basic regulation of the residential rental market was a very necessary step – especially the need to register the lease and the introduction of enforcement elements. The Act moved the market – indeed over 30,000 contracts in the first year alone – out of the wilderness and into the space where social costs and benefits beyond private profit are considered, where earnings can be taxed and, after all, where data evidence can be collated for understanding the market and improving its regulation. Both theoretical and early empirical insights suggest that the introduction of the regulation created upward pressures on rents but that these were off-set by the downward pressures created by Covid-19 effects. With a year of experience in the bag, it is now a matter of adjusting the regulation, of reducing the costs of any possible overstep to maximise the net benefits to property owners, tenants and society.

Recommendations for policy

On the basis of the discussion above, it is now possible to outline some recommendations to assist the policy maker with a view to ensuring that all eligible residential rental contracts are duly registered, and that the sector is rendered as professional and stable as possible, without generating unnecessary burdens.

In this regard, it is reasonable to expect that the incentive to register contracts will increase both with increasing awareness of the benefits of registration and with the reduction of unnecessary costs of registration. The communication drive coupled with the requirement of a registered contract from identity papers provided a strong incentive to foreign residents to demand registration. Similar incentives may operate for reticent Maltese tenants and landlords if the registration is integrated with other governmental services/benefits. It may also be the case that future communication efforts may need to specifically target Maltese households in long-term contracts.

Addressing deadweight costs and unnecessary rigidities will not only stimulate more registrations but also enhance the efficiency of the market. One such rigidity is the mandated 5% cap on the

rate of increase which, as discussed, may be suppressing longer term contracts. A minor tweak would see this requirement replaced by a requirement for the landlord and tenant to stipulate an agreed percentage within the contract (without mandating what that percentage is in the law). Another recommendation is to do away with the auto-renewal of contracts and relieve both the Authority and landlords of unnecessary administrative costs. In such a case, certainty of tenure would continue to be provided by the duration of the contract itself. An automated reminder of the date of termination of the contract could provide the intended benefits (of avoiding careless eviction) without the burden of auto-renewal by default. The mandatory inventory process can also be softened to a recommendation to landlords and tenants that recording objects of material value will be useful to both parties in case of dispute.

Agenda for further work

Beyond the tweaking of the Act, it is also possible to flag further areas ripe for assessment and intervention. One question is the issue of affordability in the Maltese context complete with an assessment of the other side of the affordability coin: incomes⁶⁹. Based on current data available from the Housing Authority, the average Maltese family could theoretically afford the vast majority of the leases registered with the Housing Authority in 2020. But a single person earning a minimum wage can only afford a shared space – an unsavoury prospect for many⁷⁰. The need for the state to address the lack of provision for the low affordability market segment therefore remains a key priority. Subsidising rents and building social housing stock is one way to go, but encouraging the market to supply this offer would cost the state less and arguably be more sustainable in the long run. This is the challenge in Malta as it is in several countries in Europe. The design of social-housing schemes that manage private sector stock merits further focus. It is also plausible to consider facilitating conversions, to enable flat-sharing through suitable and transparent utility metering, to tweak planning regulations to allow smaller but sanitary, well-ventilated units, in a manner that ensures dignity.

⁶⁹ Camilleri, D. (2011), 'A long-term analysis of housing affordability in Malta', *International Journal of Housing Markets and Analysis*, 4(1), p31-57.

⁷⁰ Based on the median household income of just over €2,600 per month and minimum salary of less than €800 per month, and estimating affordable rent as 30% of income, then the median household can afford a rent of around €780 monthly while a single person on minimum wage can afford a rent of less than €240 monthly.

Similarly, there is scope for further study on the role of tax rebates in moving the market to specific directions. If it is long term contracts that government wishes to incentivise, then for a period of time, these rebates can be aimed at incentivising renewals or contracts longer than a given time-frame; if it is quality that the government wishes to incentive, then rebates can be set as reimbursement of maintenance costs; if it is provision of low-cost rentals that is needed, then rebates can be used to incentivise conversions. Relatedly, one may also consider how best to design tax rebates and the registration process itself to limit tax evasion. The average values of registered rents are substantially lower than those observed in other studies based on advertised rates. While this is partly due to the fact that settled prices are likely to be lower than advertised with negotiation, the figures may also be capturing a degree of under-declaration which (if undetected) could suit both the tenant and the landlord.

As more data emerges, it will be possible to conduct impact assessments of the regulation on mainstream economic parameters within and beyond the housing market, such as impacts on GDP and growth, on equity, poverty relief and social cohesion, as well as on wellbeing more broadly. The Housing Authority, to date responsive to research, and keen to base policy on evidence, does well to launch further enquiry to fine-tune the Act and to remain vigilant to its direct and indirect impacts. The trick is to continue to balance market and regulatory imperfections and strengths.