

Rent control: a friend or foe

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Abstract

In this article, I address the by-product of the property reform—perpetual land lease—with a case study of Latvia. Contributing to scholarship on the challenge of property reforms after generations of dispossession, I examine the economic meaning of property restitution in this post-Soviet context. Using process-tracing and policy analysis techniques to examine the creation and implementation of Latvia's restitution policy in the aftermath of independence from the Soviet Union, I tackle the research question: "Have the property rights of the parties been considered during these reforms?" I use two theories to answer this question: one of law and economics, by applying the theory of efficient regulation and Normative Hobbes Theorem (coalesced from the Coase Theorem and the Hobbes Theorem) and the other of transitional justice, by analysing the perpetual lease relations as part of restitution policy, aimed at providing justice to victims of the Soviet occupation and nationalization. In this paper, I illustrate that state intervention by normatively fixing the lease fee is necessary to prevent infringement of property rights of the landowners, thus ensuring that restitution as a transitional justice measure has reached its aim.

Keywords

perpetual lease • regulated prices • restitution • transitional justice

Introduction

In a perfect world, if a person needs land to build a house, they will enter into a lease agreement with the landlord or establish a building right. They will agree on the rights and duties of the parties, and, foremost, the price to be paid. Such a luxury was denied to the owners of real estate in Latvia after the collapse of the Soviet Union. Restitution allowed former owners (or their heirs) to reclaim their properties. However, these had changed considerably during the 50 years of occupation. Buildings were full of tenants; previously undeveloped lands were built upon. The legislature faced the dilemma of how to balance the rights of the parties. Most Eastern and Central European states adopted a cautious stance and chose not to restore property rights to previously undeveloped land if it had since been built upon (Snipe, 2020a, p. 12). Latvia made an exception, allowing restitution in almost all the cases (Snipe, 2019b). This resulted in a situation where every second privatized apartment in Riga, the capital of Latvia, was located on land owned by another person.

The main problem in this relationship was the duty to pay the lease imposed on apartment owners, and procedural hurdles landowners face while collecting and recovering lease payments. Five amendments to the law stipulating

the reduction of lease fee amount and five judgements of the Constitutional Court of Latvia are explicit indications of an unresolved problem.

One of impediments landlords faced in collecting rent was a lack of agreement with apartment owners on the lease fee. The invoices cannot be issued before the lease is set, but establishment of the lease through the court against each apartment owner takes time and money. Could rent control—lease fee amount set in the law or by local authority—be a solution? Could landlords claim that the absence of rent control is a legal vacuum imposing an obligation on the state to adopt a law setting the lease amount in the absence of a mutual agreement?

Contributing to scholarship on the challenge of property reforms after dispossession, in this article I examine the economic meaning of property restitution. Using process-tracing and policy analysis techniques to examine the creation and implementation of Latvia's restitution policy in the aftermath of independence from the Soviet Union, I tackle the question: "have the property rights of the parties been considered during reforms?"

The hypothesis I put forward is that in case of perpetual land lease¹, it is the duty of the legislature to set the lease fee in

¹ Note: ECJ and Constitutional court of Latvia uses a term "compulsory leasing" for perpetual lease.

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the law. In this article I apply the theory of rent control and Coase and Hobbes theorems to a case of perpetual land lease relations which are established between the owners of separate immovables, i.e., when a land and a building on it have different owners and they have not agreed on the lease fee. In addition, I apply the approach of transitional justice, by analysing the perpetual lease relations as part of restitution policy, aimed at providing justice to victims of the Soviet occupation and nationalization.

I start with a short review on what is rent control, when and why was it introduced and what is its main purpose. In the next part of this article, I give an insight into perpetual land lease established in Latvia during property reform. I do not dwell on detailed description on property reform, as this can be found in my other articles (Balodis & Snipe, 2019; Snipe, 2019b) and only disclose the basic facts insofar as to illustrate the situation between apartment owners and landowners. The further parts of this article are dedicated to answer the questions as to whether controlled lease relations can be compared to perpetual land lease, and whether abolishment of rent control in perpetual lease relations prevents infringement of property rights of landowners. As Latvia's case of adopting transitional justice measures is often overlooked in the scholarship, I outlined some facts about the restitution after transition.

At the end of this article, after having argued that in perpetual land lease relations it is the duty of the legislature to set the lease fee in the law as transaction costs are too high for parties to agree on it and bargaining is deemed to fail, I outline the questions for further research, asking, foremost, how to determine a fair remuneration for the use of the land.

Rent control: when and why, pros and cons.

What is rent control?

The concept of rent control refers to a legislative framework that provides for a limit on the amount that a landlord may demand from a tenant. Globally, the concept of rent control found its footing after World War I and World War II when it was used to solve the problem of housing shortage both in Europe and in the United States. The essence of rent control is that a government or a legislature places a limit on the amount that a landlord can demand for leasing a home or renewing a lease. The goal of rent control is to keep the living costs affordable, sometimes stretching as far as to ensure housing for lower-income residents.

Mechanisms of rent control

The mechanisms of rent control laws differ widely. Without claiming full taxonomy thereof, we can distinguish between those introduced nationally and those introduced locally, by states or even municipalities (as in the U.S.). Rent control

may also take a form of a limit on a fee for renewing a lease. Most commonly, rent control means either a fixed rent price set in a law or a set limit by which a landlord can increase the rent, sometimes—until it hits a set maximum amount. Rent control may apply to fixed term leases, or it can provide the right of a tenant to ask for renewal of the lease under the same conditions perpetually.

The rent ceiling and the limits for rent increase may be set in a law or the competence to set the limit can be given to a certain authority, for instance, municipal officers (like the Rent Guidelines Board in New York City). When the rent limits are set in a law, they can be set as a specific monetary amount or in percentage of the property's value. Both types of rent controls have been known in Latvia. A rent ceiling was introduced for rent of the apartments in houses denationalized in 1990s. The former owners (or their heirs), having received back apartment houses, were entitled to receive a monthly rent from the tenants only in the amount of 0.24 santims (approx. 13 USD cents) per square meter. The tenants had the right to request the renewal of the lease term perpetually. Only after 10 years, in 2002, the law was amended to allow an annual rent increase by 0.12 santims (approx. 6–7 USD cents) per square meter. This regulation was in place until 2007, when it was abolished by the Constitutional Court (Constitutional Court of the Republic of Latvia, 2006). However, also after formal abolishment of rent ceilings, the increase in rent had to be litigated through the court and tenants had the right to request the renewal of the lease on the original terms perpetually.

Rent ceiling set in proportion to a property value is a less known type of rent control, as it requires determination of property value, but was introduced in Latvia for perpetual land lease relations which I will describe in the following sections.

When and why?

In few, if any cases rent control has been adopted because of an abstract idea that state regulation would bring better results than the operation of the laws of economics (Willis, 1950, p. 54). In almost every instance, the regulation has been adopted to respond to extreme circumstances or disastrous events. The classical examples are war and natural disasters which either destroy the housing itself, creating shortage, thus affecting supply and demand for housing, or impede the solvency of tenants, jeopardizing their ability to pay the market price of the rent. The iconic example is worldwide housing shortage which followed World War II.

John W. Willis in his compelling article on the history of rent control laws, reminds us of less known cases of rent control, for instance, rent control adopted by Greece in 1920s to respond to lack of housing caused by The Great Fire of Thessaloniki, a royal order to prohibit increase of rent in Lisbon after an earthquake in the 16th century, or special provisions adopted

by Rome in 1923 after a flood in Campagna. He reminds us also about the Papal bulls imposed on landlords in Rome in the 16th century (Willis, 1950, pp. 56, 61). The latter is an example that most notably allows drawing parallels with the case of Latvia.

Rent control entered Rome in 1555 when Pope Paul IV revoked many rights of Jews and, among others, introduced a prohibition to own real estate. The Jews were ordered to move a specially designated and walled quarter in the city—Jewish Ghetto (Aron-Beller, 2019, p. 238). The houses there were owned by Christians and the Jews were compelled to rent the property. Pope Paul IV and his successors over the next 50 years changed the rent regulations, by imposing or releasing the landlords from the duty of renting the houses to the Jews at reasonable rents, and by prohibiting (or not) the rent increase and eviction of tenants. Only in 1604 Clement VIII issued the bull *Viam Veritatis* which once and for all deprived the owners of the houses in the ghetto of the right to increase the rent or to evict the tenants, granting the tenants the perpetual right to possession or tenancy (*ius gazaga*) (Willis, 1950, pp. 60–62). Right to possession of the property in perpetuity, created by the bull, meant that the tenants had no other duties than to pay the rent, and the tenant could terminate the rent agreement at any time while the landlord was bound to this agreement forever.

A case of extreme circumstances when rent control may become handy is after change of regime in a country, using rent control as a transitional justice measure. Rent control mechanisms can be used when properties are gained and lost during transition, when property relations are changing, to protect the weaker counterpart in the transaction and to ensure that people do not lose their homes. In Latvia rent control was used first and foremost to protect tenants of apartment buildings.

Pros and Cons

Rent control strives on the idea that in extraordinary circumstances market rules are inapplicable. It is the duty of the state to interfere and to protect the basic rights of the presumably weaker party in the transaction—tenants. Rent expenses are inflexible, while other expenses of living may be cut. If rent goes up, a tenant has a choice to either pay it or move to a cheaper lodging, whereby the latter is an illusory option in times of housing shortages. Willis points out that the situation among exiting landlords and tenants is in fact a monopoly, as the tenant cannot get this product—housing—anywhere else, except where he is currently living. Thus, the excuse for the state to intervene is the classic case of protection of the rights of the weaker party in a monopoly.

Rent control is a well-researched form of price control in economics. Economists point out the cons of it, claiming that the consequences of rent control are widely regarded as being

extremely damaging to the city, lessening the quality of real estate, and destructing rental market by creating shortages of rental property (Bourne, 2014, pp. 10–12).

From the constitutional law perspective this dilemma should be solved by balancing the interests of the landlords and the tenants. In times of trouble, when free-market rules may lead to great injustice and widespread infringement of basic human right (right to dwelling), the other right (right to property), can be temporarily restricted. However, this restriction must last no longer than the extraordinary circumstances last or while it can be assumed that the market can regulate the price by itself.

Still, the history of rent control shows that once rent controls have been imposed, they are difficult to remove. In his research, Willis has observed that rent control in almost every instance had been adopted as an avowedly temporary measure, but in few cases did the legislators find it possible to dispense with controls as early as had been hoped. Even more, the longer the restrictions remained in force, the more difficult it became to abolish them (Willis, 1950, p. 71). Manoeuvring between unpopular political decisions, legislators are prone to use long lasting transition periods while the rights of the landlords are “just temporarily” infringed.

The latter was also the case of Latvia: both regarding rent for the apartments in the denationalized apartment houses and regarding lease fee an apartment owner is ordered to pay to the landowner if their house is situated on a restituted land. In both cases the rent ceilings were introduced to protect the tenants or apartment owners, and in both cases the property owners were the ones challenging the provisions in the Constitutional Court. But did the applicants reach their aim? It remains doubtful despite formally favourable decisions of the Constitutional Court.

Perpetual land lease in Latvia: transitional justice gone astray.

Restitution as a transitional justice measure

It was May 4, 1990, when the Supreme Soviet of, at the time, Latvian SSR adopted a declaration “On the Restoration of Independence of the Republic of Latvia”, setting a milestone of Latvia’s transition from a soviet republic to a democratic state. As transitional processes go, also Latvia’s case was an object to difficult decisions and faced its hurdles. While less focused on trials and truth commissions, Latvia’s transition was marked by extensive restitution policy: property nationalized by the Soviet state in between 1940 and 1980 was given back to its previous owners or their heirs.

The property reform carried out after restoration of independence had several goals and it had its limitations. It aimed to stress the state continuity of Latvia, and restoration of rights that existed before 1940 symbolized the return to

pre-occupation state. Property reform was also seen as a guarantee of historical justice towards the previous owners, who had lost their properties after the occupation of Latvia. It had the symbolic value: the previous owners were recognized as legitimate owners, despite nationalization carried out by the Soviet state. Furthermore, restitution was seen as a tool to “create owners”, ensure the transition to a market economy, and restore the significance and value of private property. And last, but not the least, Latvia favoured restitution in-kind as the newly re-established state had limited monetary resources to pay compensations, thus it favoured returning the properties in the state they currently were. Overall, as a transitional justice tool, restitution symbolically demonstrated justice for the dispossessed, previous owners (Rowen & Snipe, 2021).

Separate ownership of a land and building

Restitution in Latvia was applied to enterprises and to real estate: lands and buildings. The former owners or their heirs received back their family houses, the former tenement buildings, now full of tenants housed there during Soviet times and paying negligible rent, and the land lots their family once owned. Restoration of property rights to land was controversial in cases where once undeveloped land was built upon.

This mainly applied to the lands in the suburbs that were agricultural lands in 1940s and was developed during the 50 years of Soviet occupation as the cities grew. Often the suburban areas had large multi-apartment buildings built upon them to house people flown into Latvia from the republics of the USSR as part of the Russification policy. Nevertheless, when the parliament discussed restitution regarding to the building upon the land, the majority ruled in favour, seeing that the opposite would symbolize inability of the new regime to rectify Soviet wrongs (Snipe, 2020b, p. 19).

The only exception when the land was not returned was if a Latvian citizen had built a family house on it, then the interests of house owner prevailed. In all other cases, the former landowner could reclaim the land. And they did. Although in case the land was developed, the law gave formal alternatives of requesting an equivalent land lot or receive government issued vouchers; most choose to reclaim the land: municipalities had only limited amount of free land to offer, and people had concerns about the value and liquidity of state issued vouchers. A plot of land was a tangible asset, although an encumbered one. In this way, the land and buildings came into possession of different persons and were recognized as autonomous ownership objects (meaning, the land and the building could be bought and sold independently).

Perpetual land lease amount

As the sole purpose of the land under a building is the maintenance thereof, the legislator simultaneously with restitution granted perpetual land lease rights to the building owners. Consequently, after the apartments were privatized, the perpetual lease rights were transferred to apartment owners. Although this right cannot be sold or pledged, as *ius gazaza* was, the only duty apartment owners have, like Jews in medieval Rome, is to pay the lease. None of the parties can terminate the perpetual lease as the building is inseparable from the land. In 2012, almost every second apartment in Riga, the capital of Latvia, was located on a land owned by someone else, not the apartment owner. The State Land Service published data that perpetual land lease binds about 40% of the total number of apartments.

Perpetual land lease means that the landlords are entitled to receive lease payments from apartment owners. The paramount point of contention has always been the lease amount. Differences had arisen not so much due to the very fact the lease should be paid, although there are exceptions, but because of the amount payable. Over time, landowners have soundly expressed their discontent with rent ceilings and difficulties in collecting payments, while apartment owners complain about unpayable amounts due.

The rent level has been the reason for most amendments in the law regulating perpetual lease and has been a reason for already four decisions of the Constitutional Court of Republic of Latvia (set of fifth run cases were pending at the time this article was being prepared). The amount of the lease fee has been regulated in the law since the beginning of property reform in the 1990s. At the beginning it was set as 1.5 times the real estate tax; in 1995 the maximum amount was set as 5% per year from the cadaster value of the leased land.

Until 2007 the cadaster value was politically kept low and thus the lease fee was negligible. Moreover, it was paid by the municipality and landowners got this small income with little effort. At the end of 2007 new rules regulating the cadaster value were adopted simultaneously with new rent control provisions limiting the increase of the lease amount. At this point landlords challenged the rent control provisions—the 5% rent ceiling set in the law as well as 25% increase limit—at the Constitutional court which found them both unconstitutional. In between 2009 and 2017 the Parliament twice adopted similar provisions, either repeatedly introducing rent increase limits, or gradually reducing rent ceiling from 6% of the cadaster value per year to 5%, 4%, and even 3%, but all these amendments were contested and declared unconstitutional by the Constitutional Court (Snipe, 2020b, p. 147ff). Lease fee limits were formally abolished, at least for a while.

Could landlords celebrate their victory? Ostensibly, rent control regarding multi-apartment houses almost 30 years after the beginning of the property reform was abolished. But had the Constitutional Court succeeded and prevented

infringement of landowner's property rights—right to receive fair income from their property?

Perpetual lease or perpetual transition?

Separate ownership of land and buildings and perpetual land lease in Latvia were created as a by-product of property reform. The legal relations among the stakeholders (landowners, building owners, apartment owners, also tenants, and building managers) therefore are still being perceived as a part of property reform, not as a part of free market economy (Constitutional Court of the Republic of Latvia, 2009).

This is a transitional justice angle: restitution aims to show that the new regime will not support the injustices (Murphy, 2017, p. 113). Restitution is considered a backward-looking measure, and economists express doubts about whether this is an efficient means from the perspective of market economy (Crowder, 1994, p. 262). However, symbolic meaning of restitution often is more important than economical (Heller & Serkin, 1999, p. 1405).

Meanwhile, if restitution takes place, it should not be illusory; otherwise the goals of the restitution are not achieved. In the context of transitional justice, restitution can be a remedy for a loss of dignity taking suffered both through deprivation of property and deprivation of home, like in the Latvian case when people were evicted from their properties and deported to Siberia by the occupying power (Atuahene, 2016, p. 813). Restitution in-kind—giving back the properties as they are (in their historical boundaries, as much as possible)—in Latvia was seen by the legislature as a guarantee of historical justice towards the previous owners. Restitution (called: denationalization) was a symbol of redress for damage caused by the Soviet state.

Still, it is not judicious to evaluate the perpetual lease relationship as part of land reform forever. Search for justice as part of transition should be temporary, and after a while should be replaced by a regulation appropriate for “ordinary” circumstances. Reforms and transitions are extraordinary and temporary; the relationship created during reforms shall not stay forever under the shield of interim measures. Of course, there are no rules how long a transition may last, but regarding Latvia—a member state of NATO and the EU for almost 20 years—one could assume that the transition period is over. Therefore, I argue that the relationships, established as a by-product of applied transitional justice measures, should be regulated as “ordinary” civil law relations.

At this juncture, 30 years after the change of regime and property reform, all the people involved—landowners and apartment owners—are holders of capital. They own real estate with a determinable value. The state should find a way to regulate the legal (and economic) relationships among these capital owners according to the rules of the market economy; otherwise, one or the other party can claim infringement of

their property rights.

The right to income as part of property rights

Comparison of rent control and perpetual lease

Rent control in its classical sense (between tenants and landlords) and perpetual lease both intersect at the point of landlords' right to receive fair income from their property.

Both appellants in the AOBA v. Washington case in D.C. in 1977 (District of Columbia Court of Appeals, 1977) and applicant at the Constitutional Court of Latvia in 2008 (Constitutional Court of the Republic of Latvia, 2009) contended that absent wartime (in D.C.) or transitional (in Latvia) conditions, the imposition of rent control was not only unwarranted but unconstitutional. Appellants in D.C. viewed the rent control act as an effort to apportion the tenant's increased living expenses on his landlord. Applicants in Latvia viewed the objective in protecting “the interests of the owners of privatized objects during the land reform by thus denying the possibility to the landowners to receive full reimbursement for the use of the land” (Constitutional Court of the Republic of Latvia, 2009, para. 3).

In rent control and in perpetual lease cases both applicants and courts have used the same arguments, claiming and reviewing infringement of property rights. However, after the Constitutional Court of Latvia declared the provisions providing lease ceiling in perpetual lease invalid and while there was no regulation in place and the fee ostensibly was left for the parties or court to establish, can we allege that a fair balance between the opposed interests of the parties was ensured?

Involved rights and interests.

What are the interests that the regulation of prices should balance? For apartment owners, it is their interest to be spared unsustainable expenses. The same right—to hold to the dwelling, right to remain in the living place one is already having—shapes the rent control provisions in dwelling rent as well as in perpetual lease.

For landlords in perpetual lease, similarly as in rent control, the interest is to receive fair income from their property. However, here perpetual lease differs from tenant–landlord relations. When the apartment is rented, a landlord may have several dozens of tenants, sometimes a hundred or two. The more tenants there are, the more income the landlord has, and, presumably, the less are recovery costs. Although there is a full spectrum of landlords (from one owning a small house to one owning blocks), as well as there are different landowners (some having one small lot, while some may have dozens of properties), the essential difference is the amount owned by one debtor.

In the case of classical rent control, the tenant owes the

rent, which, even when controlled, is tenths and hundreds of times larger than the lease for the land-lot apartment owner is due. To give a Latvian example: the monthly rent of a 50 square metre apartment in a Soviet-time block house (not rent controlled) in 2020 was around 200–300 euros, while the monthly land lease payable by this apartment usually was somewhere between 1 and 5 euros.

Up until the judgement of the Constitutional Court of 2018 rent control in perpetual lease relations played a dual role: it not only prevented rise of payments but it also provided a price where there was no agreement between the parties. Abolishment of regulated prices made collection of lease fee conditional on litigation, and the court was to set the fee amount in the judgement. (Latvian Civil law has a provision that in the absence of an agreement, the lease is fixed by the court at its discretion.)

Thus, the unforeseeable consequence of the judgement was that the law did not contain any designations of fee amount. Could this lack of regulation constitute an infringement of property rights?

Property right: right to receive a fair income.

What constitutes property and property rights? Latvian Civil Law defines property as the full right of control over property, including the right to possess and use it and obtain all possible benefits from it (Civil Law, 1937, sec. 927). Similar is the notion of property as a bundle of rights known in the common law system. According to both traditions of law, the content of property is determined by the scope of rights: the right to use it for oneself and to prohibit its use by others, and the right to transfer it and to derive income from it. The theory of law and economics sees property primarily as the economic value of the rights included in it (Coase, 1960). Economically, property is a commodity, and its value is determined by market exchange.

By restoring property rights to the land that had been built upon during the Soviet occupation, only a part of the rights that compose the property were restored: landowners did not regain rights to use the property themselves, to choose lessees, or to determine the lease fee. The new owners lacked an essential element—the right to exclude, which, according to some legal theorists, constitutes the main content of property rights. “Deny someone the exclusion right and they do not have property”, wrote Tomas Merrill (Merrill, 1998, p. 730). Right to exclude means that no one can take the property unless the owner sells it willingly and at the price at which he subjectively values the property (Calabresi & Melamed, 1972a, p. 1105).

The limits of lease amount restricted landowners’ property rights—right to income (Constitutional Court of the Republic of Latvia, 2009, para. 12.1). Such restrictions are permitted, but

they must be proportionate, meaning, they must not impose obligations that go beyond what is necessary in the public interest and the obligations imposed must be proportionate to the aim pursued.

Any deprivation or restriction of rights reduces the value of the property (Miceli, 2011, p. 113). Consequentially, if the decision has been adopted to restore property rights as part of transitional justice, the subsequent deprivation of the property though regulatory takings shall not be considered neither constitutional, nor in line with the aims of transitional justice. If the property rights are restored, these should not be illusory or unfeasible, but contain some substance—being it the right to use the property or the right to receive income. Otherwise, one may ask—what is given back? Restitution is illusory if none of the rights constituting the property are enforceable.

When searching a balance between the interests, the value of the property should be considered, as it declines if severe rent controls are introduced. This cannot be the aim of a property reform in a democratic society.

What is a remuneration?

The Constitutional Court of Latvia admitted that if the maximum amount of the possible income from leasing a property is defined in a law, then the property rights of the owner are restricted (Constitutional Court of the Republic of Latvia, 2009, para. 11, 2018, para. 21). This conclusion is not unique only for Latvia, this has been recognized by the European Court of Human Rights (European Court of Human Rights, 1979, para. 63) as well as Supreme Courts of the U.S.: almost every jurisdiction which has enacted rent control laws has recognized that the landlord must receive a reasonable return on his investment, or the control will be an unconstitutional taking (McNeely, 1986, p. 173).

The practical problem is the estimation of a reasonable return. In Latvia, neither the legislator, nor the government, nor the Constitutional Court, or courts dealing with individual cases have come with an acceptable and substantiated answer.

If the land property is seen as an alternative investment, remuneration should provide for a right to receive a fair return on the capital. Massachusetts Supreme Judicial Court in 1971, hearing a rent control case, reiterated the law that defined a fair net operating income as “that income which will yield a return, after all reasonable operating expenses, on the fair market value of the property [...] The fair market value of the property shall be the assessed valuation of the property [...]” (Supreme Judicial Court of Massachusetts, 1971). The court ruled that “fair net operating income” requires that rents are set to assure a reasonable return on landlords’ investments.

Net operating income (NOI) is a standard calculation used to analyse the profitability of income-generating real estate investments. NOI equals all revenue from the property, minus all reasonably necessary operating expenses. The main

problem with using NOI in the law is the huge disparity in the expenditure landowners incur.

Necessary operating expenses

In Latvia, the perpetual lease entered the public agenda only almost two decades after the property reform, as until then the fees were politically kept low and were paid by municipalities. However, once the apartments were privatized, municipalities ceased to pay the lease and apartment owners had to pay it themselves. On the eve of 2008, new rules governing the cadaster value were adopted, which meant that in the cities the cadaster value and, consequently, the lease payments grew (Rowen & Snipe, 2021).

Having lived a considerable part of their life in socialism where the land was owned by “all the Soviet people” or being used that the land lease is being paid by the municipality, the apartment owners were reluctant to pay it. Building managers used legal loopholes to evade the responsibility to pay; however, suing individual apartment owners each for a small debt is an expensive and time-consuming endeavour. Therefore, landowners often allowed the lease debt to accumulate before filing a petition, and even then, litigation costs may exceed the potential income.

Of the operating expenses of the landowner, only one position—real estate tax—is a constant. Other expenses are transaction costs: search costs, bargaining costs, and enforcement costs. These costs may vary from zero to indefinitely large, and the perpetual lease relations hit almost all the checks of characteristics pointing to higher transaction costs (Cooter & Ulen, 2012, p. 91). Many hostile, unfamiliar parties, often unreasonable behaviour, delayed exchange, costly punishments, and insufficiently certain rights: all these indicate higher transaction costs.

What are the exact numbers? The problem is that they vary much. I present the examples of applicants in the case No. 2017-17-01, showing the lease amounts payable at the rate of 6% of the cadastral value per year and contested 3% rate (see Table 1).

What these numbers mean for a landowner? Mainly the fact, that transaction costs, if dealing with separate apartment

owners, in most cases constitute a high percentage of possible income. If the yearly lease for an apartment is 70 euro, and 70 euro is the minimum state fee payable to sue a debtor, the transaction costs are unproportionally high.

Landowners in Latvia often face a problem that landlords in Massachusetts and California do not: transaction costs to collect the lease are so high that NOI tends towards zero. Latvian law did not provide for an efficient debt recovery procedure even when the lease amount was set in the law. However, since the law did not contain provisions determining lease in the absence of an agreement, the litigation was unavoidable.

As the right to receive income is recognized as part of property rights, failure to establish an effective procedure to collect the payments is an infringement of landowners’ property right—the right to receive income from the property.

Can rent control be used to redress the infringement of property rights?

Separate ownership of land and buildings was intended to be temporary. In drafting the land reform laws, members of the Supreme Council assumed that by including the provisions of redemption, repurchase, buy out, or pre-emption, properties will be merged, and separate ownership and compulsory land lease issues will disappear (Snipe, 2020a, p. 13). However, this did not happen.

Are state regulated prices in the case of separate ownership still relevant? I argue that yes. In a free market, the equilibrium price is determined by demand and supply. In a situation with separated ownership bilateral monopoly means there is no market, none of the parties has the option of choosing another contractor. Under these circumstances the market fails and the state intervention in determining a fair compensation is acceptable (Snipe, 2019a).

I argue that state intervention is not only acceptable, but also necessary to prevent infringement of the property right of landowners. In perpetual lease, bargaining will predictably fail due to unproportionally high transaction costs. Back in 1960, Roald Coase wrote that an efficient use of resources results from private bargaining; however, only when transaction

Table 1

Applicant	Land lot (Sq m)	cadaster value of leased land	Lease (6%)	Lease (3%)	number of apartments	av. yearly lease per apartment (6%)	av. yearly lease per apartment (3%)
Dz71	1300	36852	2211.12	1474.08	106	20.86	10.43
B35	3520	194314	11658.84	7772.56	192	60.72	30.36
Ū24	4940	243781	14626.86	9751.24	166	88.11	44.06
M112	999	48162	2889.72	1926.48	18	160.54	80.27

costs are zero. In real world transaction costs may vary considerably: in order to carry out a market transaction it is necessary to discover the other party, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, and to undertake the inspection needed to make sure that the terms of the contract are being observed. These operations may be so costly to prevent many transactions that would be carried out in a world in which the pricing system worked without cost (Coase, 1960, p. 15).

As follows from the Coase theorem, the threshold level of transaction costs divides the spectrum into a region in which bargaining succeeds and on in which it fails. In case of perpetual lease, as illustrated by some (anecdotal) examples, transaction costs are extremely high due to a large number of payers each owning a comparatively small amount. Coase admits that there may be situations when “the administrative costs might well be so high as to make any attempt to deal with the problem within the confines of a single firm impossible. An alternative solution is direct Government regulation” (Coase, 1960, p. 17).

The Coase theorem approaches transaction costs as something external, depending on the situation, but not related to the law. However, sometimes the legislative framework is the one facilitating a settlement. Coase is clear that, on occasion, governmental administrative regulation can even lead to an improvement in economic efficiency, *inter alia*, by lessening the transaction costs (Coase, 1960, p. 18). While Coase was pessimistic about government interventions, believing that government often makes things worse, he accepted that in rare occasions the price system is too costly (Bertrand, 2010, pp. 991–993). This conclusion is applicable to the case of perpetual lease, as the latter also affects many initially unidentified subjects—apartment owners.

If the apartment owners are obliged to pay for the entitlement—right to use the land, one should find the simplest way to minimize the administrative costs of enforcement. It is obvious, that market valuation of each separate case is inefficient. Here the state should intervene by both establishing the initial entitlement and determining the compensation payable (Calabresi & Melamed, 1972b, pp. 1092, 1110).

In the theorem he named after Thomas Hobbes, “The Hobbes Theorem”, Robert Cooter suggests that the role of the law is to minimize the inefficiency that results when bargaining fails, by restricting the threats which the parties can make against each other (Cooter, 1982, pp. 17–19). This function of the law shall be apparent in collective bargaining. While thinking about a theory of bargaining which removes obstacles to cooperation, Cooter has coalesced the Coase Theorem and the Hobbes Theorem into Normative Coase and Normative Hobbes Theorems, whereby the former encourages to structure the law so

as to remove the impediments to private agreements, but the latter to structure the law as to minimize the harm caused by failures in private agreements. The law should be designed to prevent coercive threats and to eliminate the destructiveness of disagreement. In other words, if transaction costs are low, the law should remove the impediments in private agreements, but if transaction costs are high, the private agreements are deemed to be impossible, and the law should eliminate the destructiveness of disagreement (Cooter & Ulen, 2012, p. 92).

Normative Hobbes Theorem provides the answer for perpetual lease, when in most cases transaction costs are too high for parties to reach an agreement. When bargaining fails due to impediments, agreement should be replaced by the control of Leviathan-like entity (Bunting, 2014, p. 900). Contrary to classical normative Hobbes Theorem, I argue that the authority to set the price shall not be conveyed to the court, as litigation costs are unproportionally high. Transaction costs may be kept low only if the price is set in the law or set by administrative authority (regulator or municipality) in a simple, collective, and cost-effective procedure.

This answers the question posed at the beginning of the article, namely, that under perpetual lease the law should allow the parties to agree on lease; however, should any impediments arise and disputing parties fail to bargain, the regulations should award a simple, clearly defined private property right to the party who would have otherwise acquired the right in a hypothetical zero-transaction cost.

Conclusion

The economic theory of law discussed in this article gives a strong response that the market failure created by separate ownership of land and buildings (especially when these are multi-apartment buildings) can be solved only by regulated prices. More difficult is to determine this price, if set in the law. Under bilateral monopoly the market fails to provide equilibrium. Extra difficulty lies in the fact that the land under buildings is almost a public good—available and accessible to everyone and element of exclusivity cannot be satisfied here. Another challenge is a perception of the property being a thing not rights (de Soto, 2017, pp. 19, 25, 27), whereby the rights to use is accorded a higher position than the rights of ownership (Marcuse, 1996, p. 135). This perception stems from Soviet law, as well as the perception that “non-labor income” (including rent) is not ethical and should not be encouraged (Marcuse, 1996, p. 136). Also political conditions—dissatisfaction of apartment owners about the property reform—contribute to unsuccessful bargaining and market failure. Clearly, none of the stakeholders is satisfied: for landlords the lease is too small and too costly to collect;

for apartment owners lease is too high, they feel it is unjust to pay for land.

Policy analysis acknowledges that public policy and the law may encourage, discourage, prohibit, or prescribe private actions. This is based on the premise that individuals generally act in their own best interest. Government may influence the private choice if it can provide rationale (Weimer & Vining, 1999, p. 58). Thus, to stipulate the lease fee in the law, the amount should be determined in line with the aims of the public policy. The political decision has been adopted to merge the properties thus the lease amount should be set to promote the buyout (being it right to buy or duty to sell).

Takings law undertakes to transfer property where two factors are present: where the taker is the superior owner of the property and where strategic barriers block voluntary transfers to the superior owner. The superior owner—the person who values the property most—in case of perpetual lease is the apartment owner. When the land and building coalesce into a single real estate, its value (and value of each apartment in this building) is higher than the sum value of the encumbered land, which can be used just for lease, and the apartment encumbered with a duty to pay lease.

Both from an economic point of view—to increase the value of the property and from a social point of view—to reduce conflicts between groups of owners, public policy and regulatory pricing must be aimed to promote merging of properties. This means both creating a legal framework to exercise the buyout rights (as opposed to eminent domain) and creating motivation for landowners to sell and apartment owners to buy the land. The latter can be achieved, *inter alia*, by introducing regulated prices for land use which are easy to collect (preventing unjustified infringement of property rights of landowners) but satisfies no one. In other words, landlords are to receive a little less than they could get by immediately selling the property and investing the money elsewhere, but apartment owners are to pay more than the increase in their capital (increase in the value of the property) achieved by buying the property.

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