The Portuguese Housing Market

Francis left the notary on a sunny day in the spring of 2008 with a wonderful feeling. Having inherited an apartment in Lisbon, he finally owned something: an asset and the full right over its future income stream. Francis had plenty of reasons to be a happy landlord; or did he?

The 2008 inheritance

It all began in the 1950s when Francis’s grandfather, William, decided to make an investment: he purchased three buildings in a new area of Lisbon called “Avenidas Novas” (literally, “new avenues”). In order to provide low-cost housing to a large fraction of the population, the political regime at the time (the so-called “Estado Novo”) offered various fiscal benefits to owners who accepted low rents. William took the deal and so the apartments were rented at below-market-value rents.

When William died, the apartments were divided among his descendants. For example, Elizabeth, the youngest of William’s children, had eight children of her own. Theresa and Edward inherited the apartment in which they lived in. Peter, Harry and Nathan inherited apartments rented to non-family members and became tenants of their aunts. Finally Francis, Richard and James, who had lived outside of Lisbon for a long time, inherited apartments occupied by non-family members.

As the new deeds was signed, the nominal value received by each heir was determined to be the same; but considering the different situations of each tenant and/or landlord, the outcomes differed considerably. With rent controls in place, the value of an apartment depends considerably on the rights of tenants to remain in place while paying the same low rent. The new owners inheriting apartments occupied by older tenants considered themselves luckier, but that did not mean a lot as Portuguese law allows for rent-controlled leases to be transferred, for example, from parents to their children.

Portugal’s tenancy laws

Before 1990, Portugal did not have a structured law concerning urban leases: there was an accumulation of isolated pieces of legislation, most dating back to the 1910 and 1974 political revolutions. Broadly speaking, the law tended to favor the tenants' interests: rents were artificially kept below market prices; contracts were unlimited in length and could be transferred among family members; and eviction procedures were slow and ineffective.

Written by Marta Faria under Luís Cabral’s supervision for the purpose of class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. © 2015 Marta Faria, Luís Cabral.
The first systematic legislation regarding the Portuguese housing market was the 1990 Urban Lease Law ("Regime de Arrendamento Urbano"). All the existing legislation was brought together in a single text, eliminating gaps, discordances, duplications and contradictions. The new law allowed for greater flexibility in contract duration as well as setting rent value. (Two previous laws, from 1981 and 1985, already allowed for new contracts with no rent controls as well as the updating of old rent values; but these laws had limited practical effect.)

**Regulation’s costs and benefits**

The fraction of home owners in Portugal is very high with respect to other European countries. Partly this results from favorable mortgage conditions: for many years, low interest rates and government subsidies implied that the monthly payment required for acquisition was not very different from the corresponding value of a free-market rent. More important, regulatory restrictions in private rental market made renting an unattractive option.

Although home ownership is generally seen as an important policy goal, when it is artificially achieved — as was the case in Portugal — it may also have its costs. Take for example William’s family. Having access to housing at low cost, most children and grandchildren decided to raise their families and develop their professional careers in Lisbon. In one case, Peter had an excellent job offer in Oporto — Portugal’s second largest city — but declined it, partly because moving to Oporto would imply paying a much higher market rent.

In other words, artificially low rents imply a high opportunity cost of moving out: were Peter to move to Oporto he would most likely have to pay a market rent — or purchase an apartment. This lack of economic mobility may have important economic costs.

An additional cost of rent controls is the lower investment incentives. Since tenants did not pay market-level rents, landlords refused to pay for their apartments’ maintenance. This resulted in a degradation of many buildings, threatening the architectural heritage of several city centers.

**A dual market**

All of the above problems were in the legislator’s mind in the buildup to the 1990 reform. However, by creating (or restoring) an unregulated rental market for new rentals, the 1990 law effectively led to a new problem: a dual market, whereby rental contracts first written before 1990 were treated very differently from contracts first written after 1990.

Exhibit 1 illustrates this point; it shows that rent per square meter for contracts written after 1990 (and before 2006) was about 50% higher than contracts written before 1990. (This is true both for Lisbon and for the country as a whole.) However, one must be careful about reading these numbers: During the 1990s relatively few real estate owners sought to acquire new properties for rental purposes. This suggests that the difference in rental values is primarily due to the 1990 legislation — and an indication that rents were indeed artificially low with respect to market values.

A dual market adds one more problem to the rental market, namely equity. There were multiple situations of blatant injustice, with some tenants paying extremely low rents even if their economic status did not justify such treatment.
Recent reform

The New Urban Lease Act ("Novo Regime de Arrendamento Urbano") of 2006 was the first reform introduced to the law of 1990. There had been previous attempts to update the values of old rents (and thus avoid the dual market referred to in the previous section). That goal had not been achieved primarily because of administrative reasons: the updating was based on the official evaluation of the dwellings; however, by 2006 most buildings had not been assessed.

The Ministry of Finance then decided to carry out a process of assessment of all the dwellings in the country. A December 2012 deadline was set. Landlords were given the option of requesting an earlier assessment in exchange for a fee. However, many landlords opted for not requesting an assessment: although a higher value was the premise for a possible increase in rents, it was also sure to imply an increase in taxes.

Then came the 2008 economic crisis. Although Portugal did not suffer from the same housing market collapse as neighbor Spain, the economy shrunk considerably and sovereign debt rose to critical levels. The request for a bailout came with some strings attached: the creditor “troika” — the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) — demanded a series of market reforms in exchange for loans. A push toward a true and unified rental market housing market was an important component of the troika memorandum.

Reviving the dysfunctional rental market will improve households’ access to housing and foster labour mobility. Rental regulation is cumbersome, tenant protection is very strong and eviction procedures difficult and slow, hampering the functioning of the rental market. A large number of apartments in city centers remain empty, causing a substantial waste of capital as well as additional costs in terms of welfare, equity, transport, and environment. The lack of a rental market hampers geographical labour mobility and contributes to a high structural unemployment rate. This situation, as well as tax incentives, has encouraged house purchases and the building up of household indebtedness ("The Economic Adjustment Programme for Portugal," European Economy. Occasional Papers 79, June 2011).

The 2012 law introduced some substantial changes. First, the parties were given greater freedom to fix contract duration. Second, the negotiation between tenants and landlords became more important, as after the 2006 law rents were being updated in accordance with pre-established criteria. Third, the transition period from the old contracts to the new regime was shortened. Finally, a new extrajudicial process was created to ease and accelerate eviction procedures. A leasing contract today in Portugal is anything but standardized: the law foresees à la carte contracts in which the parties can freely agree on the terms they want.

At the moment, only a few years after the most recent reform, it is difficult to measure the effectiveness of the real estate laws. This is mainly because the liberalization of the market is being implemented gradually, particularly for tenants with less favorable socio-economic backgrounds.

The apartment’s key

When Francis inherited his apartment in 2008, then-tenant Mr. Almeida was paying a monthly rent of 116.80 euros. That year Francis paid 782.58 euros in total expenses. Out of
that value, 660 corresponded to condominium expenses, the remainder to small maintenance expenses and taxes. In 2010 the owners of the building decided to add an elevator to the building and, as a result, Francis’s negative cash flow more than doubled that year. Similarly, in 2012, the exterior of the building that had to be insulated and painted. While Francis included these expenses as costs for tax purposes, he considered them more like investments, increasing the future value of the apartment.

Mr. Almeida died in 2009. Mrs. Almeida remained in the apartment. The Portuguese leasing law allows for one contract transfer, which in most cases is between family members. However, handovers between spouses are not considered transfers. Therefore, Mrs. Almeida could still transfer her contract to a third person.

In 2013, as a consequence of the new leasing law, Francis asked Mrs. Almeida for a rent increase. According to the market value of the apartment, Mrs. Almeida should have been paying 600 euros per month (the apartment’s market value is 250,000 euros). However, the tenant argued to be a low-income citizen, presenting the necessary documents to prove her status. The new law declares that if the tenant is unable to pay the market rent during the following five years, then rent values should be increased depending of the tenant’s level of income. If the situation does not change after those five years, then the rent is raised to its market level and the government pays a subsidy to the tenant to cover their income gap, a subsidy which is attached and defined according to the leasing contract. Accordingly, in 2013 Mrs. Almeida’s rent rose to 154.30 euros per month.

Mrs. Almeida died in 2014. When Francis asked to be given the apartment’s key, Mrs. Silva, the live-in nurse who took care of Mrs. Almeida during her illness, invoked her right to remain as a tenant. This is because Portuguese law allows contracts to be transferred between close relations as well as family members.

At this point Francis refused to receive any more rents, hired a lawyer, and sought to evict Mrs. Silva from the apartment. Mrs. Silva claimed the right to remain in the apartment because she lived in what is called “economia comum” (common wealth) with Mrs. Almeida. But Francis’ lawyer discovered that in 2013, when Mrs. Almeida presented documentation to prove she was a low-income individual, she failed to include Mrs. Silva’s income. Mrs. Silva lost the case and on February 5, 2015, Francis went to his lawyer’s office to get the apartment key. He then took his two daughters to inspect the apartment. Although its condition was good, it needed some remodeling.

“What should we do now that we actually own it?,” asked Helen, Francis' older daughter. “To rent or not to rent, that is the question!” was all that Francis could answer.
Exhibit 1
Average monthly rent as a function of initial contract year

Exhibit 2
Francis’ annual income and expenses

<table>
<thead>
<tr>
<th>Year</th>
<th>Monthly rent</th>
<th>Annual income</th>
<th>Annual expenses</th>
<th>Net cash flow</th>
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<tbody>
<tr>
<td>2008</td>
<td>116.80</td>
<td>934.40</td>
<td>782.58</td>
<td>151.82</td>
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<tr>
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<td>116.80</td>
<td>1401.60</td>
<td>706.61</td>
<td>694.99</td>
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<tr>
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<td>1925.95</td>
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<tr>
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<td>1401.60</td>
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</tr>
<tr>
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<td>1401.60</td>
<td>2244.42</td>
<td>-842.82</td>
</tr>
<tr>
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<td>134.79</td>
<td>1617.46</td>
<td>2487.36</td>
<td>-869.90</td>
</tr>
<tr>
<td>2014</td>
<td>154.30</td>
<td>771.50</td>
<td>774.86</td>
<td>-3.36</td>
</tr>
</tbody>
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