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Urban density, law and the duration of real estate leases

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ABSTRACT

This study explores the relationship between a country's legal system and how its cities develop by examining the considerable variations in commercial real estate lease duration (or term) across both countries and cities. We find that the cross-country variation in lease duration and building construction is related to the content (common versus civil law) and efficiency (integrity and enforceability) of the legal system in the respective countries. First, we find that countries with a common law system and lower levels of corruption tend to have longer leases. Second, we find that in the United States, high-rise Class A office buildings tend to have tenants with longer term leases, suggesting that the advantages associated with being able to write and enforce a long term lease is particularly important for the development of high-rise office buildings. Finally, we find that there are in fact more high-rise office buildings in countries with more efficient legal systems.

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1. Introduction

Starting with La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998, henceforth LLSV), there is a growing literature that examines how cross-country differences in legal systems influences economic development. The evidence from this literature suggests that a country's legal system (whether or not it is based on common law) and the level of corruption are positively associated with the development of financial markets and economic growth (Demirguc-Kunt and Maksimovic, 1998; Levine and Zervos, 1998; Mahoney, 2001; La Porta et al., 2008).

Given the connection between urbanization and economic development,¹ it is natural to explore the link between a country's legal system and how its cities develop. While our analysis is not designed to identify a causal relationship between the legal system and characteristics of real estate markets, we provide suggestive evidence by combining the following three ideas. The first is that a more efficient legal system, which facilitates the resolution of conflicts, allows for the use of longer-term contracts. The second is the potential spillover benefits associated with having a stable tenant base, which we conjecture can lead to the optimal duration of leases being longer for high-

rise office buildings. Finally, given the evidence that increased urban density facilitates economic growth and increases productivity (Rosenthal and Strange, 2004) we conjecture that if a better legal system facilitates the development of more high-rise office buildings, that this may contribute to the observed positive association between economic growth and the quality of the legal environment.

As discussed in the literature on contract duration,² (e.g., Joskow, 1987; Crocker and Masten, 1988; Brickley et al., 2006), long term contracting can be quite important in situations where there are potential hold-up problems, and these problems are particularly important in the context of real estate leases where there are considerable costs to both the tenant and landlord associated with moving. In addition, there can be positive spillovers associated with having a relatively stable tenant mix, which might give a building owner further incentives to have longer term leases. It is likely that lenders and other providers of capital would also find it more attractive to provide financing for the development of a high-rise building that was able to secure long-term leases with key tenants.³

² Within the context of this paper, the terms lease duration and lease term are used synonymously.

³ As the development of high-rise buildings requires the pre-commitment of significant amounts of capital, the ability to attract and contract with a higher quality tenant mix may facilitate securing financing for the project. In addition, there tend to be tenants in high-rise buildings that provide services to other tenants and longer-term leases may keep the tenant mix stable and facilitates the investment in these services. These factors suggest a stable tenant mix will make high-rise office buildings more attractive to tenants, developers and lenders.

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¹ Recent papers by Henderson (2003a,b) examine the link between urbanization and economic development. For a review of the earlier literature see Glaeser (1996).

However, long-term leases require effective mechanisms for dealing with conflicts that can arise within the term of the lease. For example, the landlord may fail to maintain the building or to provide promised services, like trash removal. The tenant may be disruptive to other tenants or take actions that hurt the value of the property. These conflicts can be resolved by simply having the tenant move out when they have a short-term lease, but may require litigation when the tenant has a long-term lease. Hence, we expect to see longer duration leases in countries with a legal system that allows for the efficient resolution of these disputes, and shorter duration leases in countries with less efficient legal systems.

To explore these ideas we first examine the cross-sectional determinants of lease duration using two data sets provided by CB Richard Ellis. The first data set, which allows us to explore the importance of cross-country legal differences, provides typical lease terms in 185 cities and 57 countries around the world. Our regressions estimate the relation between the lease duration reported in this data set on measures of the content and efficiency of the legal system, economic development and the number of high-rise buildings in each city. The second data set, which we use to examine the relation between property types and lease duration, includes information on individual lease contracts on office space within the United States. Finally, using data from Skyscraper.com, we estimate the relation between the legal environment in these 57 countries and the relative number of high-rise office buildings and skyscrapers in each city, defining a high-rise building to be more than 35 m tall or more than 12 floors and a skyscraper to be more than 100 m tall or more than 30 floors.

In our first set of regressions, we find a strong and robust positive relation between lease duration and a country's legal origin. Leases in common law countries tend to be longer than leases in civil law countries. This result is consistent with the observation by Djankov et al. (2003) that tenant/landlord conflicts are more quickly resolved in common law countries. We also find that lease duration is shorter in countries that are considered to be more corrupt. In our second set of regressions, which examine data on individual U.S. office leases, we find that tenants in high-rise buildings tend to have longer-term leases. Since we expect no impediments to the utilization of long-term leases in the U.S., we interpret this regression as indicating that the advantages associated with longer-term leases are particularly important for the development of high-rise buildings. All else equal, this should make high-rise office buildings relatively more attractive to develop in countries with legal systems that allow for the efficient enforcement of the terms of a long-term lease.

In our final set of regressions, we examine the association between the legal system and the number of high-rise office buildings per capita. We find that all else equal, there are more high-rise office buildings in common law countries, and countries with less corruption. This last result is consistent with our conjecture that more efficient legal systems, which facilitate the use of long-term contracts, can influence the development of cities.

The paper is organized as follows. Section 2 discusses the association between the legal system, lease duration, building density and economic growth. Section 3 discusses the association between market liquidity and the duration of real estate leases. Section 4 discusses the association between the economic environment and the duration of real estate leases. Section 5 describes the sample and methodology. Section 6 presents the results and Section 7 draws some conclusions.

2. Legal system, contract duration and urban density

This section discusses how differences in the legal system between countries can potentially influence the duration of commer-

cial real estate leases and through this urban density and economic growth.

2.1. The efficiency of the legal system

Using survey data from over 109 countries, Djankov et al. (2003) examine the efficiency of the legal system by estimating the time it takes to resolve, via the courts, the eviction of a nonpaying residential tenant. They find that legal systems based on civil law are less efficient, being associated with higher expected duration of court proceedings, less consistency, less fairness in judicial decisions, and more corruption, particularly in developing countries. This finding is consistent with the observation that common law evolved to protect private property rights and as a result facilitates the ability of private property owners to initiate longer term contracts (Hayek, 1960; Merryman, 1985; Mahoney, 2001). In contrast, civil law was designed to limit the role of the judiciary and solidify state power, restraining the courts from interfering with state policy. Moreover, civil law countries tend to place direct restrictions on the ability of individuals to contract. For example, in France the statutory term of a long-term lease is 9 years, but the lease has break points every 3-years allowing the tenant to vacate.

Accordingly, countries that have adopted common law tend to place more emphasis on the protection of private property rights than countries adopting civil law. All else equal, this suggests that we would expect longer-term contracts in common law countries. To test for this relationship we define an indicator variable that takes a value of one if the country's legal system is based on common law and zero otherwise. As an alternative measure of the efficiency of the legal system, we include the number of days taken to resolve tenancy disputes counted from the moment the plaintiff files the lawsuit in court until the moment of actual eviction, which we take from (Djankov et al., 2003). This measure includes both the days where actions take place and waiting periods between actions.

In addition to the content of the law, the integrity and efficiency of the law – its strength and impartiality, are also important. Integrity reflects the extent to which individuals and/or corporations can rely on the legal system to make and implement laws without bias (that is, the laws are not designed to benefit one party at the cost of the other parties to the contract). To measure the integrity of the legal system we use the Corruption Perception Index (Transparency International), which reflects the extent to which corruption is perceived to exist among public officials and politicians. We reverse the index, which ranges from 0 to 10, with larger values indicating more severe corruption.

In the context of real estate leases, the corruption index proxies for the threat of all or part of the landlord's and tenant's rights being expropriated by the courts or public officials. We expect that higher levels of corruption will be associated with shorter-term real estate leases, since short-term leases limit the potential for the expropriation of the landlord's and tenant's rights.

Given the evidence that legal systems are less efficient in developing economies (Djankov et al., 2003), we include a developed economy indicator variable that takes a value of one if the country is classified as a developed economy according to the World Bank classification based on countries' gross national income levels. The inclusion of this indicator variable can potentially capture aspects of the legal system that are not encompassed by our other measures, and as we will discuss below, it might also be related to overall economic uncertainty, which can also be related to the optimal duration of leases.

Finally, we recognize that the structure of real estate laws can vary between countries, particularly, in terms of the existence of specific legislation regulating commercial real estate leases. We

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