Benefits of Rent Stabilization: A Brief Overview

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Prepared for the State of Oregon House Committee on Human Services and Housing

Informational Meeting of February 28, 2017

Summary

A well-designed moderate rent stabilization program increases tenant and community stability and reduces displacement by providing renters with stable and predictable rents in areas suffering unreasonable rent increases. In these areas, where a shortage of housing has given landlords an unfair advantage in bargaining power, rent stabilization and eviction for good cause ordinances establish a more balanced set of rights and responsibilities between tenants and landlords. A well-designed rent stabilization program restrains increases in “scarcity rent”, increases that are over and above the rent level actually necessary to profitably operate and maintain the property. Rent stabilization can also help to ensure buildings are properly maintained and discourages speculation. Moderate rent stabilization programs have no effect on new construction. Moderate rent stabilization programs generally allow full or partial decontrol when a tenant moves. This provides tenants with stable rents and slows the rate at which rents increase, but it does not hold down rents permanently and does not ensure the long-term affordability of rental housing. Rent stabilization is an essential policy for preventing displacement and giving tenants stable housing costs. It is not a panacea, but rather one essential housing policy tool among many.

About the Author

Stephen Barton has a Ph.D. in City & Regional Planning from the University of California, Berkeley and is the author of numerous academic articles, book chapters and professional reports on housing policy, housing economics, rent stabilization and mandatory homeowners associations. Now retired, he served as Director of the City of Berkeley Housing Department and Deputy Director of the Berkeley Rent Stabilization Program. His work has received a National Planning Award from the American Planning Association, a Leadership Award from the Non-Profit Housing Association of Northern California and a Research Award from the Community Associations Institute. He is currently Co-Chair of the Committee for Safe and Affordable Homes and serves on the Mayor’s Housing Advisory Committee in Berkeley.

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1. Introduction

Moderate rent stabilization programs are used ensure that tenants in the private, for-profit rental housing market have stable and predictable housing costs, which greatly reduces the displacement that results from rapid rent increases. Moderate rent stabilization programs typically limit annual rent increases using a formula based on the increase in the consumer price index, provide full or partial decontrol when a tenant moves, with rent stabilization starting again at the new, higher rent level for the new tenants, and provide for landlords to petition for additional increases if they are needed to receive a fair return. They slow the rate of increase in rents, but do not hold them below market permanently. This type of rent regulation is very different from strong rent control programs, which do try to hold rents down permanently and do not allow increases when a tenant moves. Its purpose is to maintain affordability for current and future tenants based on the rent they felt they could afford at the time they moved in.

In what follows I will discuss the purposes of moderate rent stabilization, the underlying economics of rent regulation, and discuss some common misunderstandings that lie behind much of the opposition to these programs. This review is informed by the academic literature on housing policy, by my personal experience over twenty-five years as an administrator in implementing a wide range of housing policies, including rent stabilization, in the City of Berkeley, and by my observations of the San Francisco Bay Area housing market over the past forty years.

2. *Stability and Security for Tenants*

Rental housing is owned by the landlord as a real estate investment and at the same time it is rented by the tenant as a home. Stability and security in one's home is essential to a decent life. For tenant families, stability means they are better able to concentrate on jobs and school and to maintain the ties of family and friendship that are deeply important to them. For the surrounding community, stability among neighbors helps create the social ties necessary for a safe and supportive community.

The real estate industry typically argues that community stability is best maintained through homeownership, because homeowners are "stable" and renters are "transient". But many people are unable to afford to buy a house or condominium for long periods of their lives and some will never be able to buy. These people are also entitled to stability. There is an extensive public health literature demonstrating the harmful effects of stress, particularly on children and the elderly. Forced moves are among the major stress factors. Rent stabilization with good cause required for eviction has proved to be an effective means of making tenants more stable, especially in areas with rising rents. During the current economic boom in the San Francisco Bay Area, cities with rent stabilization have had very limited displacement, while cities without such protection have seen widespread displacement of lower-income tenants.

Many economists criticize rent stabilization because it reduces tenant mobility and this, they say, reduces the economic efficiency of the rental housing market because it gives tenants an economic incentive to stay in one place. Note the change in language. Transience and mobility, stability and immobility are word pairs that mean the same thing. The first uses the civic language of community to favor stability. The second uses the economic language of efficiency to favor mobility. Economists know that homeownership reduces mobility, but they rarely criticize it as inefficient. Instead, they have supported it with research demonstrating that stability creates significant public benefits. For some reason only renters are supposed to have their lives subjected to the rigors of economic efficiency, in which a family or elderly person's lifetime of community ties count for little weighed against enabling a someone with a higher paying job to move closer to work.

There is a broad consensus in the economic literature that rent stabilization stabilizes renters. That is certainly born out in my personal experience in Berkeley and my observations of the housing market in the San Francisco Bay Area.

3. *Limiting Unreasonable Rent Increases*

Rent stabilization provides stability by limiting "unreasonable" rent increases, so what makes a rent "reasonable" or "unreasonable"? Under a reasonable approximation of the perfect competition typically assumed to exist in a market for consumer goods, competition between landlords holds down the rent to the minimum necessary in order to profitably operate and maintain rental housing. A perfectly competitive market provides its own rent control, allowing rents to increase by just enough to cover increases in operating expenses and maintain the value of the net operating income from which the owners draw their profit. The courts have held that a rent stabilization system that mirrors the effects of a perfectly competitive market and provides rent increases sufficient to cover operating expenses and maintain the value of net operating income in relation to inflation meets the constitutional legal requirement for "fair return on investment".

Broadly speaking, rent increases greater than the increase in overall consumer prices are above what a fully competitive market would allow. Moderate rent stabilization programs implicitly define a "reasonable rent" as the rent that would be charged in a housing market that is reasonably competitive. These programs hold the rent below what the market will bear in the seriously impaired markets they are responding to, but moderate rent stabilization programs ensure that the landlord receives a rent that is at least equal to and usually greater than what the rent would be in a fully competitive market.

There are several major reasons why the rental housing market is not adequately competitive in many parts of the U.S., particularly successful urban areas. One cause is restrictive land use regulations that limit increases in supply. The single largest governmental barrier to increased supply of rental housing is single-family zoning, and since that is backed by the voting power of the American middle class, it is not going away. It protects homeowners' property values but the supply restriction has significant costs for tenants and first-time homebuyers.

The second major cause is high cost of construction in urban areas. In-fill development at high density is more expensive than building low-rise apartments on vacant lands and requires more highly skilled construction workers. In the San Francisco Bay Area so much multi-family housing is under construction, especially in rent stabilized cities I might add, that there are shortages of building contractors with the necessary capacity and construction costs have increased rapidly.

Finally, there are time lags in construction and in the "filtering down" process. New housing is typically aimed at the upper levels of the rental housing market and is not affordable to most tenants. They live in older rentals and it is only after a substantial amount of time has gone by that age and the development of newer housing results in the "filtering down" process that can make rental housing affordable to tenants with average or below-average incomes. Gardeners have a saying that the best time to plant a tree is twenty years ago. The best time to have a boom in rental housing construction is twenty years before the economic growth that creates major increases in demand for rental housing at all incomes, so that a good stock of older housing will be available when it is needed. Obviously that's not the way the housing market works.

Real estate is different from other commodities that are rented or sold. When a person rents a house or an apartment, they rent both the building and the location of that building. When the market fails to hold rents down to the minimum level necessary to profitably operate and maintain rental housing (Adam Smith called this amount the "building rent") that is because a condition of scarcity allows the owner to charge an additional amount of rent for access to the neighborhood, city or even metropolitan area in which the building is located. Adam Smith called this "ground rent", later economists usually call this "land rent" or "locational rent". This is simply an admission charge for the privilege of living in a desirable area, and as Adam Smith and later economists point out, it is not the landlord but the larger society that makes an area desirable. This admission charge generates "windfall" or "unearned" profits that are over and above those actually earned by provision of housing and related services.

There is a common real estate industry saying that the three main factors determining whether a property is a good investment are "location, location and location". Increases in land value and land rent generate the maximum return with the minimum investment from the real estate owner. When demand for a location increases, buildings can get much higher rents with only low-cost cosmetic improvements. The result of the new, higher rents is that tenants who have lived in a neighborhood for some time have to choose whether to remain close to family and friends, or have a reasonable commute that allows them to spend time with their families, at the cost of not meeting other urgent needs, or moving away at great cost to their social support network.

The value of the location is generated by inter-related factors including government investment in infrastructure and provision of essential services, private economic activity in the surrounding area, the rate of population growth, diversity and creativity of the culture, and the quality of the natural environment, among others. This value is created by all of us, homeowners and tenants alike. If we accept the idea that people are entitled to the value they create and are not entitled to value they do not create, then, since land rent is a creation of the larger society, the larger society has the right to regulate that rent or recapture it through taxation rather than simply allow it all to be taken as private, unearned profit. The larger society then, has a right to regulate rents for community benefit and enable tenants to remain in the communities whose value they too have helped to create.

Economic theory tells us that if the impact of a regulation or tax falls on the future increases in land or locational rent, then it will have no effect on the profitable operation and maintenance of the building, which is covered by the building rent. This is why most rent stabilization ordinances appropriately define a "fair return" as a rent that enables the landlord to maintain the same "net operating income" (gross rental income less all operating expenses such as management, maintenance, taxes and insurance) as the property had in at the beginning of rent stabilization, adjusted for inflation. Moderate rent stabilization programs simply slow the unearned increase in land rent to mitigate its most harmful effects on tenants.

4. Encouraging Maintenance by Supporting Code Enforcement

A typical criticism of rent stabilization is that because it restrains rent increases landlords will not be able to maintain their buildings and the result will be deterioration of the rental housing stock. This is based on an incorrect economic model that, again, assumes perfect competition. In a housing market with limited competition, making the usual assumption of profit maximization, the landlord's decision on maintenance is not based on the absolute rent level, but rather on the difference between the rent received when the property is well-maintained and the rent received when it is poorly-maintained. In a tight housing market where very low-income tenants have few alternatives, landlords renting to very low-income tenants will be able to get almost the same rent in either case and will gain greater profits from a lower level of maintenance.

In high rent areas we often find deterioration of rental housing and people living in apartments with extensive code violations even though they are paying more than renters in other areas pay for good quality housing. This is not because the landlords cannot afford to maintain their buildings at these rent levels. It is because under conditions of scarcity tenants have few or no alternatives and so they have no bargaining power. What rent stabilization and requirements of good cause for eviction can do is give the tenant bargaining power. The tenant can bring in housing inspectors to do code enforcement and appeal to the rent stabilization program for a rent reduction until the code violations are corrected. And they can do this knowing that they are protected against retaliatory eviction.

Rents in California cities with rent regulation have rents that are below market for the area, but still above the market rents in other parts of the country that have more balanced housing markets. It is hard to argue that landlords cannot afford to maintain their property when they receive a regulated rent that is just as high as or higher than the market provides in other areas of the country, and just as high or higher than would be provided by a fully competitive market.

5. Discouraging Speculation

Ensuring adequate maintenance is also important to help reduce speculative and ill-informed investment in rental housing. The presence of rent stabilization often results in prospective buyers being more careful in analyzing rental property. In addition, better codes enforcement reduces the extent to which new investors overpay for rental property based on an income inflated by under-maintenance. A history of under-maintenance can result in unexpected problems, while too high a price paid for the building may result in insufficient resources to correct the situation.

"Speculation" in real estate refers to investment based on an expectation of future increases in rents and property value due to scarcity, as opposed to productive investment in renovation of a building that earns higher rents through improving the quality of the building. (Real estate investors often combine both productive and speculative investment.) Speculation will have harmful effects when it results in overpaying for investment property or over-mortgaging it so that the landlord lacks resources to deal with unexpected major maintenance or renovation needs. The economics literature considers this a form of "market failure", often referred to as "the winner's curse", because investors with overly optimistic assumptions will "win" ownership of an investment property over more realistic investors.

Speculation can change the type of landlord who owns rental property. Small landlords who manage their property themselves and intend to hold it for a long time often prefer stable tenants over immediately maximizing rents. This is because there are costs to finding new tenants and because new tenants bring unknowns in terms of how they will treat their rental housing and how they will get along with other tenants. Buyers who intend to "flip" a property as soon as rent increases are sufficient to raise property values will push out such long-term tenants in favor of maximizing rents. Rent stabilization with eviction for good cause greatly reduces such behavior.

When landlords in areas with comparatively high rents or rapidly increasing rents argue that they are losing money or making only a very limited profit from their investment in rental property, it is often the result of overpaying for or over-mortgaging the property in the hope of continued rapid rent increases in the future. The landlord's right to a "fair rate of return" is subject to the use of good business judgment and does not establish a right to rent increases to compensate for paying a price for the property based on speculative future rent increases, failing to accurately estimate a property's operating and maintenance costs or renovation costs resulting from deferring needed maintenance. Within the real estate industry it is well understood that mortgage payments are an investment expense, not an operating expense.

6. No Effect on New Construction

In the San Francisco Bay Area construction of multi-family housing is substantially higher in cities with rent stabilization than in cities without it. This does not mean that rent stabilization causes new construction. It simply means that rent stabilization is more likely to be implemented in cities with higher proportions of renters, and renters are also less likely to oppose development of higher density housing that will bring more renters into the community. It is in cities primarily made up of homeowners that local politics is overwhelmingly opposed to development of multifamily buildings because of negative stereotypes of renters, and fear of increased density, which is too often identified with congestion and crime instead of walkable neighborhoods with high levels of access to cultural and educational facilities.

Well-designed rent stabilization systems have no effect on new construction. The initial rents will be whatever the market will bear at the time of initial occupancy and current programs typically provide an exemption from rent stabilization, either indefinitely or for a substantial period of time. There is simply no empirical evidence that rent stabilization has discouraged new construction. There is a running joke that the City bird of San Francisco is the construction crane.

The same might be said of Berkeley, where there is more apartment development currently under way than at any time in the past forty years.

7. *Concluding Comment*

Much of the argument against rent stabilization is based on a model of a perfectly competitive housing market that does not exist in large parts of the country. Like public utility regulation, rent regulation ensures basic fairness in a market where consumers lack bargaining power.

Back in 1978, when California cities were first considering rent stabilization ordinances, opponents would point to areas of New York suffering from reduced property values and abandonment, ignoring the fact that many other cities without rent controls were also suffering the same problems, and predict a similar grim future for California if the ordinances were passed. After nearly forty years of rent stabilization, anyone can visit San Francisco or Berkeley, or New York for that matter, and see that they are thriving cities. Now some opponents of rent stabilization claim the exact opposite, that rent stabilization is responsible for San Francisco's high rents. This ignores the fact that housing costs are just as high in nearby Bay Area cities without rent stabilization. One of the driving factors is that almost the entire Peninsula located between San Francisco and Silicon Valley has highly restrictive single-family zoning despite enormous job growth over the last few years. This benefits homeowners in these areas and inflicts major costs on tenants and first-time homebuyers. The other major factor is that San Francisco is built out, so the only way to increase supply is to build up, at very high densities, which is extremely expensive and serves only the luxury end of the rental market.

There is no better policy tool than rent stabilization for preventing displacement and ensuring that private sector tenants have predictable housing costs that allow them to settle into a community. It is not a full solution to the affordability problems of low-income people. Moderate rent stabilization programs generally allow full or partial decontrol when a tenant moves. This provides tenants with stable rents and slows the rate at which rents increase, but it does not hold down rents permanently and does not ensure the long-term affordability of rental housing currently affordable to low-income people. For this reason, it is also essential to increase the supply, both of market-rate and of permanently affordable below-market rate housing, and to provide ongoing rent subsidies for the very poor, who cannot afford to pay a rent just sufficient to cover operating and maintenance expenses. And of course it is also essential to deal with the roots of poverty and work for full-employment and living wage jobs. Rent stabilization is one among many useful housing policy tools, but it is the essential tool for providing renters with predictability in their housing costs and stability in their homes.

8. *Some Useful readings*

W. Dennis Keating, Michael B. Teitz & Andrejs Skaburskis. *Rent Control: Regulation and the Rental Housing Market,* Center for Urban Policy Research, New Brunswick, 1998

Still the best and most accessible single volume on rent control, covering economic, administrative and legal issues, and its history generally and six different cities.

Lee S. Friedman, *Microeconomics of Public Policy Analysis*, Chapter 13, "The Control of Prices to Achieve Equity in Specific Markets", pp. 507 – 549, Princeton University Press, 2002

Explains the microeconomic framework of rent controls in relation to increasing land values and demonstrates that the outcome of rent controls is indeterminate until policies of the regulatory program are specified, including its scope and administrative and enforcement mechanisms.

John Gilderbloom, *Invisible City: Poverty, Housing and New Urbanism*, Chapter 4, "Pros and Cons of Rent Control", pp. 67 – 101, University of Texas Press, 2008

Reviews the evidence and discusses what rent stabilization can and cannot do.

Joshua Ambrosius, John Gilderbloom et al. "Forty Years of Rent Control: Re-examining New Jersey's moderate rent local policies after the great recession", *Cities,* 49 (2015) 121 – 133.

Demonstrates that the critiques are greatly overblown when applied to moderate rent control systems, but shows they do not solve long-term affordability problems.

Edgar O. Olsen, "What Do Economists Know About the Effect of Rent Control on Housing Maintenance?" *Journal of Real Estate Finance and Economics*, 1:3 (1988) 295 – 307

Classic article demonstrating that economic models are indeterminate unless they make assumptions about behaviors that depend on the program structure chosen and that rent stabilization can improve maintenance.

Stephen Barton, ""Land Rent and Housing Policy: A Case Study of the San Francisco Bay Area Rental Housing Market", *American Journal of Economics and Sociology*, 70:4 (2011) 845 – 873.

Establishes that land rent is a major component of Bay Area rents and, as it increases, transfers wealth from renters to landlords.

Beth Wilson, James Frew, "Apartment Rents and Locations in Portland, Oregon: 1992 – 2002", Journal of Real Estate Research, 29:2 (2007) 201 – 217.

Establishes that land rent increased in the Portland area, with a resulting transfer of wealth from renters to landlords, even before recent major rent increases.