



The Economics of Residential Rent Control

A Not-So-Simple Matter of Supply and Demand

BY STEPHEN BARTON

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Graffiti in support of rent control, location unknown, March 2009.

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AS THE UNITED STATES EMERGED FROM THE FINANCIAL CRISIS AND recession of 2007–2009, rents in many areas increased rapidly, reaching previously unheard-of levels. This resulted in a massive and continuing transfer of wealth from tenants to real estate investors, displacement of hundreds of thousands of tenants, and a major increase in homelessness. In response, several cities in California and New York passed the first new rent control ordinances in over 30 years and there are serious efforts to eliminate state-level prohibitions on rent controls in Illinois, Oregon, and Washington. In California, a broad coalition of community and tenant organizations put an initiative measure on the November 2018 ballot to repeal statewide restrictions on local rent controls. The ballot measure lost, but the effort received national publicity and brought renewed attention to the case for rent control.

Much of the economic literature critical of rent control is based on analyses of the stringent controls established during World War II, which lasted into the 1970s in New York City and parts of Europe. This generation of rent controls sometimes held rents below the level necessary to operate and maintain the controlled buildings, delivering short-term benefits to tenants at the cost of long-run deterioration. These findings simply do not apply to modern “second generation” rent control systems. Throughout the United States the courts have established that landlords have a constitutional right to a fair return on their investment, which typically requires annual increases in rent ceilings sufficient to cover increases in operating and maintenance costs and an increase in normal cash flow (profit) so that the value of that cash flow is not reduced by inflation. Economist Richard Arnott suggested that in light of this, “economists should reconsider their blanket opposition to current rent control systems and evaluate them on a case-by-case basis.” Research on the practical effects of second generation rent controls has come up with mixed results, largely because to be effective rent controls must be part of a broader set of programs. You will not learn about that from the public policy discourse found in the news media or, indeed, from most economists.

Rent control can provide tenants with stability and fair rents in cities where the rental housing market is unable to stabilize rents on its own. It can protect millions of tenants very quickly and at low cost, with its administration paid for by fees charged to the landlords benefitting from increased rents. The opponents of rent control claim the “science” of economics has shown that rent control is not only ineffective but harms the low and moderate-income people it is intended to help and endangers needed housing development. When closely examined, however, these claims prove to be based on simplistic, misleading models of the rental housing market and to ignore important non-monetary human values in favor of a utopian idealization of “the market.”

A Choice of Values

Rent control provides tenants with stability and predictable rents. The real estate industry has long told us that homeownership is good because it increases community stability, while renters are “transient.” Then when tenants demand the stability that can be provided by rent control the real estate industry switches from the civic language in which stability is a virtue to the economic language of efficiency so that harmful “transience” becomes beneficial “mobility.” In the economics literature, it is said that rent control results in “reduced mobility” and that this causes an “inefficient allocation” of rental units. This is typically illustrated with stories about a few high-income tenants who choose to remain in a rent controlled apartment rather than move into a higher-rent apartment closer to a new job or of a size more suited to their current needs. It is never illustrated with the stories of the low-income seniors, childcare workers, and others who are able to stay in their community rather than being pushed out entirely because they could not afford the current market rent for any size of apartment. Nor do the analyses focused on mobility distinguish between moves that people make voluntarily to improve their lives and moves forced by increasing rents (displacement). There is a substantial medical and sociological literature documenting that the displacement of low-income people creates severe stress, with long-term health and mental health impacts—costs that receive no attention from the economics literature.

When there is a shortage of any good, rising prices ration the existing supply, allocating the scarce good to those willing and able to pay the most. If we let prices ration scarce housing, we are saying that high-income people are more deserving of access to the neighborhood or city of their choice than low-income people, and that the time people have lived in an area and the presence of family and friends is important only to the extent that it is backed up by an ability to pay higher rents.

Housing Is Not a Simple Commodity

Mainstream economists and the real estate industry typically argue that affordable housing crises are a simple matter of supply and demand. In a typical statement, the National Multifamily Housing Council, a major industry association, assures us that rents “provide the economic incentives needed to attract new investment in rental housing, as well as to maintain existing housing stock. In this respect,

housing is no different from other commodities, such as food and clothing—the amount producers supply is directly related to the prevailing market price.” In this model, rental housing is a simple commodity and the rental housing market is self-correcting, so that rising rents will quickly generate additional supply and restore affordability, while rent controls will necessarily result in reduced maintenance and less construction of new housing.

In the real world, rental housing is a far more complex commodity than tomatoes or shirts, and those complexities create serious problems in matching supply with demand. Among the barriers to perfect competition is the fact that demand for housing is dependent on its location. Apartment modules can be built in a factory in Idaho and

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shipped for hundreds of miles to California, but unlike smart phones, their value when assembled depends on where they are ultimately located.

Housing Prices Include Land Value and Land Rent

Housing necessarily sits on land, whose value as a location is created by the larger society rather than by the building owner. Much of the value of rental housing in California comes from competition for access to coastal locations with growing job markets and high levels of natural and cultural amenities. In *The Wealth of Nations*, generally considered the founding work of market economics, Adam Smith pointed out that the “rent of houses” can be divided into the “building rent,” the rent actually necessary to operate and maintain the building, and the “ground rent,” which reflects demand for a desirable location. Smith went on to say that ground rent is a “species of revenue which the owner, in many cases, enjoys without any care or attention of his own.” The real estate industry knows this quite well. It is virtually impossible to attend a real estate conference without hearing, multiple times, that the three most



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important determinants of whether an investment in real estate will be profitable are “location, location, and location.”

What the industry loves about increases in land value is that they require little, if any, investment on the part of the property owner. Instead they result from the private and public actions of the residents in making their community a good place to live, typically some combination of government services and investment in infrastructure, neighborhood amenities, and private investment that increases employment. The real estate industry argues that rent control forces the landlord to “subsidize” tenants, when in fact the landlords are extracting unearned land rent from their tenants, taking publicly created value for private profit.

Adam Smith argued further that “though a part of this revenue should be taken from (the owner) in order to defray the expenses of the state, no discouragement will thereby be given to any sort of

industry. ... A tax upon ground-rents would not raise the rents of houses.” He was one of the first in a long line of economists, the most notable American being Henry George, who recognize that land-value taxation is “efficient” because it taxes value created by the larger society, not the value created by the property owner or the property owner’s employees. This analysis of land rent also applies to rent control, which can be used to limit increases in land rent without reducing the rent below what is actually necessary to operate and maintain the building.

When it is possible to sufficiently increase the supply of housing at a desirable residential location, then the location will not be scarce and market competition will eliminate the land rent. Some inland locations are surrounded by flat, easily buildable land in all directions. But especially in coastal cities, geographic constraints limit the potential to increase the supply of housing. Since these limited urban areas are largely built out, they can only increase housing supply through increases in density, and this increases the per-unit

PAUL KRUGMAN GETS IT WRONG TWICE IN ONE COLUMN

Opponents frequently point to “liberal economist Paul Krugman,” winner of a Nobel Prize in economics, to show that liberals and conservatives alike oppose rent control. On June 7, 2000, Krugman wrote a column in the *New York Times* about a story published on the previous day describing how dozens of applicants for apartments offered for rent in San Francisco were trying to impress prospective landlords with resumes, credit reports, and personal enthusiasm. Krugman knew this must be caused by rent control, even though he stated that he “didn’t know a thing about” the San Francisco housing market. “Landlords don’t want groveling—they would rather have money. In uncontrolled markets the question of who gets an apartment is settled quickly by the question of who is able and willing to pay the most.” But under San Francisco’s rent-stabilization system, rents for new tenancies are set by the landlord without restriction and then controlled again based on the new initial rent. These landlords could easily have raised their asking prices or had prospective tenants bid against each other, so what was really going on?

San Francisco was in the midst of the first dot-com boom. Thousands of newly hired, highly paid tech workers were moving into the city and rents were skyrocketing. Some landlords had not realized how high they could raise the rents, and were learning this when so many prospective tenants showed up. Other landlords were unsure whether the dot-com boom would last and wanted to get stable tenants rather than risk having tenants move out a few months later and have to re-rent the apartment at a lower rent. And in fact, when the dot-com boom collapsed in 2002, thousands of tech workers lost their jobs and rents went part of the way back down for a few years before turning upward again. So the story Krugman read the day before reflected the effects of incomplete knowledge and economic uncertainty rather than the effects of rent control.

Krugman followed this error with yet another. He claimed San Francisco had “an absence of new apartment construction, despite those high rents, because landlords fear that controls will be extended.” In fact, rising rents had already resulted in a substantial increase in apartment construction that continues to this day. The fact that Paul Krugman could produce a column of such breathtaking inaccuracy demonstrates the hold that simplistic models of the rental-housing market have on even top-level economists.

construction cost. Geographic constraints are exacerbated by the real estate industry's successful century-long campaign to identify the single-family home as the "American Dream" and to create land-use regulations that exclude higher-density housing from single-family neighborhoods.

The opponents of rent control invariably claim that high housing costs are entirely the result of government interference with the market through exclusionary land-use regulations and that eliminating them will allow the market to become fully competitive and solve the supply problem. This ignores the other limitations of geography and increasing costs of production with increasing density. A recent study from the Federal Home Loan Mortgage Corporation estimates that two-thirds of San Francisco's excessive housing cost is the result of its geography, since 75% of the area within 50 miles of its downtown is under water or on steep hills, and another third of the excess housing cost is the result of restrictive zoning. It also ignores the disconnect between supply and demand that results from two other factors that distinguish rental housing from other commodities: its high development cost and its long life.

There Is a Disconnect between Supply and Demand in Rental Housing

The real estate industry endlessly repeats the claim that the rental housing affordability crisis is a "simple matter of supply and demand" and that increased supply is the only legitimate response. This is quite understandable, since this approach preserves the current massive transfer of income from tenants to real estate investors indefinitely. A very long period of time is required to substantially increase supply when adding 2% to the housing stock in a given year is a high rate of production. Currently, California is adding less than 1% per year and there is already a statewide and nationwide shortage of skilled construction workers that will take years to overcome before production can substantially increase. In areas with growing economies, it is hard for housing production to keep up. Nor is there any certainty that increased production of new housing will be sustained long enough to reduce rent burdens on most tenants.

Rising demand for rental housing increases rents throughout the rental-housing stock but does not generate additional housing supply at all price levels. Supply can only be added through



new construction, and the expected rent for a newly constructed building must be enough to profitably pay off the costs of its construction as well as meet the ongoing costs to operate and maintain it. Then, once much of the cost of construction is paid off, after the first decade or so of operation, the property can be profitably operated and maintained at a substantially lower rent. If continued new housing construction pulls higher income tenants away from buildings as they age, then owners of the older buildings will compete to attract tenants and will bring rents down closer to the minimum necessary to profitably operate and maintain the building. This process is called "filtering down." Most tenants live in older rental housing because they cannot afford the rents necessary to pay off the costs of construction but can afford to pay enough for a landlord to profitably operate and maintain the building once the construction costs are paid off.

However, there is no market mechanism to ensure "filtering" will happen or that the amount of housing that filters down will match the need for it. The Joint Center for Housing Studies at Harvard University reports that multifamily housing production increased for several years, but as vacancy rates have risen at the high end of the rental market,

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A sign from the Rally to Save NYC, a protest in favor of stronger tenant laws and repeal of laws favoring landlords and developers, New York City, May 14, 2015.

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multifamily housing production has declined, even though vacancies remain low in the rest of the rental market. The only way to directly respond to the growing need for housing with lower rents is for government to subsidize the costs of new construction, thus creating what is commonly referred to as “affordable housing” where rents only need to cover the costs of operation, maintenance, and a renovation reserve.

Increases in the rents charged for older housing cannot result in the production of additional older housing. They simply inflict hardship on tenants and transfer income from non-owners to owners. Their only “purpose” is to ration access to scarce rental housing based on who can pay the most money. These are the increases that are limited by rent controls.

Rent control needs companion policies because landlords will work to evade regulation by finding other more profitable ways to use the rental housing under their control.

Rent control, in its various forms, reduces the hardships caused by rent increases that result from a scarcity of older housing. It provides an alternative method of rationing access, giving priority to security of tenure and stability rather than to whoever has the most money. Modern rent-control systems in the United States exempt new construction, which makes sense because that is the sector of the rental housing market in which price increases will generate additional supply. This in turn explains why the empirical literature finds that modern rent control systems have no discernable effect on new construction.

Tenants Lack Bargaining Power Under Conditions of Scarcity

Since rent control simply limits the level of land rent, and owners receive at least as much rent as they would in a perfectly competitive market, they will have the revenue necessary to profitably operate and maintain their property. To evade this conclusion, opponents of rent control typically make two self-contradictory arguments: that increased

supply will stabilize and even lower rents without reducing maintenance, but that if rent controls stabilize rents somehow landlords will be unable to maintain their property.

When they are not simply hypocritical, arguments that rent controls will result in reduced maintenance and lower housing quality are based on a simplistic understanding of the rental housing market. Maintenance is not a direct response to the amount of rent paid but rather to the differential between the rent that can be obtained for well-maintained versus poorly maintained rental housing. In a tight rental housing market, reduced maintenance may not result in much of a reduction in rent, especially for those landlords with lower-income tenants who have few alternatives and little bargaining power. We see this routinely with low-income tenants in coastal California, who often live in substandard conditions yet pay rents that would be well above average in other parts of the United States.

Rent-control systems under which landlords can evict tenants only with good cause (i.e., for good reasons such as non-payment of rent or damaging the unit rather than for complaining about poor maintenance) can help re-establish the differential by empowering tenants to call for code enforcement and petition the rent control program for rent decreases for code violations. A study of Washington, D.C., found that code violations declined after rent control began and that the exempt housing stock had a higher rate of deficiencies than the housing under rent control. A recent review of the empirical literature sponsored by the National Multifamily Housing Council, which is hostile to rent controls, found that “rent-controlled buildings potentially can suffer from deterioration or lack of investment, but the risk is minimized when there are effective local requirements and/or incentives for building maintenance and improvements.”

Rent Regulation Must be Part of a Broader Program to be Effective

Rent control needs companion policies because landlords will work to evade regulation by finding other more profitable ways to use the rental housing under their control. A frequent finding in studies of rent control is that some landlords will convert their rental properties to condominiums and sell them to owner-occupants, thus reducing the overall stock of rental housing. Local governments have control over condominium conversion and often ban this

response by landlords. Alternatively, some cities treat this as a desirable effect and pass accompanying legislation to give tenants a right of first refusal to buy their apartment, provide them with down-payment assistance, and offer lifetime leases to those who don't want to buy. There are also a few landlords who have sufficient income from property in other cities that they can afford to hold buildings vacant in protest against rent control. Vacant building taxes provide one potential response. As the latter situation makes clear, what is involved here is a power struggle, not simply the impersonal forces of the market at work.

Rent control systems in New York City and in a few other cities have "vacancy control," meaning that rents are not allowed to increase to current market levels when a tenant moves out and a new tenant moves in. It is often claimed that landlords will select higher-income tenants over lower-income tenants to reduce non-payment of rent, so that rent control will not benefit the tenants who need it most. There is some evidence to the contrary from the experience of Berkeley under strong rent control, where it appeared that apartments continued to circulate within the same social circle as tenants moved out. In addition, Berkeley allowed landlords to obtain higher rents when they rented to tenants receiving federal Section 8 assistance, leading to high participation in that program. Nonetheless, the landlord maintains control over the selection of new

tenants, so it could be useful to explore providing incentives to encourage landlords to rent lower-rent units to lower-income tenants.

Many rent control systems allow rent to jump to whatever the market will bear between the departure of an old tenant and the arrival of a new tenant, a policy called "vacancy decontrol." A cap on rent increases starts up again at the start of a new tenancy. (This type of system is often called "rent stabilization" in contrast with stronger "rent control.") Since these systems can be evaded by evicting long-term tenants, they are normally accompanied by a requirement that landlords show "good cause" for evictions. Landlords faced with a combination of rent control, vacancy decontrol, and good cause for eviction requirements may become less tolerant of minor lease violations and increase evictions for cause. Cities can deal with this by providing emergency rental assistance to renters who suffer short-term loss of income and by requiring that landlords provide tenants with sufficient opportunity to correct a lease violation. This portfolio of policies—vacancy decontrol, rent control, good cause, and emergency rental assistance—reduces displacement. Since rents rise to the market level as tenants move, such systems do not maintain affordability over the long run and other affordability programs are necessary.

The power of the real estate industry is such that sometimes policy moves the wrong way, as



THREE MAINSTREAM ECONOMISTS HIDE THEIR OWN FINDINGS

Economists Rebecca Diamond, Timothy McQuade, and Franklin Qian recently conducted a sophisticated study of the effects of the 1994 expansion of rent stabilization to two- to four-unit properties in San Francisco. Their study found that thousands of renters were able to remain in San Francisco due to rent controls. It also found that the owners of the newly regulated small buildings shifted 15% of the units out of the rental market, mostly by converting them to condominiums, and that this loss of rental units increased market rents. Having found effects that both reduced and increased gentrification, the authors proceeded to make the much-publicized claim that "rent control has actually fueled the gentrification of San Francisco, the exact opposite of the policy's intended goal." What they really found was that allowing condominium conversion had fueled gentrification and undercut the positive effects of rent stabilization.

They also found that the overall financial benefits to tenants were still higher than the costs that resulted from allowing condominium conversions. But they hid this finding by explicitly omitting from their calculations the "benefits for renters who moved into the impacted units in later years (after 1994) which presumably were also quite large" and by closing the study in 2012, just after the end of the recession and before the rapid rent increases of the last six years. As a result, opponents of rent control routinely make the false claim that this study showed that the benefits of rent control to one group of tenants were entirely offset by its costs to other tenants. The authors conclude that a massive program of rent subsidies would work better than rent control, but make no suggestions for where the money might come from. It appears that three mainstream economists were so deeply attached to market solutions that they were unable to accept their own findings.

shown by the abolition of rent controls in Massachusetts in 1994, the abolition of vacancy controls in California in 1995, and the many state-wide prohibitions on local rent controls. In any place where rent control is needed because the market does not supply sufficient housing affordable to lower-income tenants, the long-term goal should be to provide capital subsidies to build up the supply of permanently affordable housing owned by nonprofit housing corporations, limited-equity cooperatives, and community land trusts. Social ownership protects against political changes hostile to the presence of low-income residents. That is a very long-term and expensive solution, but taxes on land value or land rent would be one very fair way to raise the money. The California cities of Berkeley and East Palo Alto increased their taxes on the gross receipts of residential rental properties to fund affordable housing and homelessness prevention, as close to a tax on land rent as state law allows.

Finally, many people don't make enough money to afford even the minimum rent necessary to pay for the ongoing operation and maintenance of rental housing. Even when the rental housing market is working well, or if there is a substantial supply of socially owned housing rented at cost, the lowest-income people will need rent subsidies or, better yet, higher wages and a guarantee of a decent income for those unable to work.

Rent Control and Human Rights

Rent control is one of many efforts to uphold human dignity by expanding human rights, those rights which are held to be inherent in all people, and restraining forms of private property that give owners power over non-owners. Economist and historian Albert O. Hirschman described three rhetorical themes consistently used by opponents of human rights. These themes, which he called "the rhetoric of reaction," are: *perversity*—the argument that a reform will harm those it is intended to help; *futility*—the argument that a reform will do no good; and *jeopardy*—the argument that the reform will endanger progress already made. This is an accurate description of the arguments made against rent control and in defense of the power of real estate investors to exact unearned land rent from tenants. Opponents claim it will harm tenants by

reducing the supply of rental housing through conversion to owner-occupancy, result in reduced maintenance to match lower rents, and endanger the new construction needed to house a growing population. But as we have seen, the rental housing market is not a simple matter of supply and demand. Instead, it is inherently prone to failure and persistent scarcity in urban areas with growing economies. When demand far outstrips supply, only rent regulation has sufficient scope and timeliness to stabilize tenants' lives, reduce forced displacement, and limit the hardships caused by unfair and unnecessary rent increases. **D&S**

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SOURCES: Joshua D. Ambrosius, et al. "Forty years of rent control: Reexamining New Jersey's moderate local policies after the great recession," *Cities* (2015); Richard Arnott, "Time for Revisionism on Rent Control?," *Journal of Economic Perspectives*, Winter 1995; 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* (fundaffordablehousing.org); Stephen Barton, "Land Value, Land Rent and Progressive Housing Policy," *Progressive Planning*, Fall 2010 (fundaffordablehousing.org); Sean Beckett & Elias Yannopoulos, "Is Geography Destiny," Freddie Mac, September 2017 (freddiemac.com); Rebecca Diamond, Timothy McQuade, and Franklin Qian, "The Effects of Rent Control Expansion on Tenants, Landlords and Inequality: Evidence from San Francisco," National Bureau of Economic Research, Working Paper 24181, January 2018 (nber.org); Lee S. Friedman, *Microeconomics of Public Policy Analysis*, Chapter 13, "The Control of Prices to Achieve Equity in Specific Markets," Princeton University Press, 2002; Henry Grabar, "Rent Control is Back," *Slate*, Oct. 17, 2018 (slate.com); Michael Hiltzik, "Proposition 10," *Los Angeles Times*, Oct. 19, 2018 (latimes.com); W. Dennis Keating, Michael B. Teitz & Andrejs Skaburskis, *Rent Control: Regulation and the Rental Housing Market*, Center for Urban Policy Research, New Brunswick, 1998; Neil Mayer, "Rehabilitation decisions in rental housing: an empirical analysis," *Journal of Urban Economics*, 1981; Nicole Montojo, Stephen Barton and Eli Moore, *Opening the Door for Rent Control: Toward a Comprehensive Approach to Protecting California's Renters*, Haas Institute for a Fair and Inclusive Society, University of California, Berkeley, September 2018 (haas institute.berkeley.edu); E. O. Olsen, "What do economists know about the effect of rent control on housing maintenance?," *Journal of Finance and Economics*, 1988; Manuel Pastor, Vanessa Carter, and Maya Abood, *Rent Matters: What are the Impacts of Rent Stabilization Measures?*, Program for Environmental and Regional Equity, University of Southern California, October 2018 (dornsife.usc.edu); Lisa Sturtevant, *The Impacts of Rent Control: A Research Review and Synthesis*, Multifamily Housing Research Council, Washington D.C., May 2018; Miriam Zuk and Karen Chapple, "Housing Production, Filtering and Displacement: Untangling the Relationships," Research Brief, Institute of Governmental Studies, May 2016 (urbandisplacement.org).