Benefits of Rent Stabilization

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1. Introduction

Moderate rent stabilization programs ensure that tenants in the private, for-profit rental housing market have stable and predictable housing costs. This greatly reduces the displacement and accompanying hardships that otherwise result from rapid rent increases. Rent stabilization in California protects tenants by limiting annual rent increases using a formula based on the increase in the consumer price index. When a tenant moves voluntarily, the landlord can charge the new tenant whatever the market will bear, with rent stabilization starting again at the new, higher rent level for the new tenants. Landlords can petition for additional increases if necessary to receive a fair return and tenants can petition for rent reductions if the landlord fails to adequately maintain the apartment. Rent stabilization slows the rate of increase in rents, but does not hold rents 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 and it is the only way to effectively prevent displacement.

In what follows I will discuss the purposes of moderate rent stabilization, the underlying economics of rent regulation, and some common misunderstandings that lie behind much of the opposition to these programs. A quick overview is followed by more detail on each issue.

2. *Quick Overview of Rent Stabilization and Its Benefits*

I. Rent stabilization slows displacement and guarantees a fair return on investment to landlords

The unbalanced rental housing market in the San Francisco Bay Area results in major rent increases that cause hardship and displace tenants and disrupt family and community life. Rent stabilization programs in California hold rent increases to the rate of inflation, so that the "real" rent remains stable, and they allow additional increases when a tenant moves voluntarily. The result is that renters have stable and predictable rents and landlords are guaranteed a fair return on their investment. In fact, they receive a higher return than they would have received in a properly functioning market with a balance between supply and demand. They just can't raise rents as quickly as the dysfunctional, unbalanced rental market would allow them to.

II. Rent Stabilization helps a broken market behave more like a competitive market

In a fully competitive market, landlords compete for tenants, charging the lowest rent at which they can profitably operate and maintain the rental unit. In a broken market, tenants compete for a place to live and lower income tenants lose their homes to people with higher incomes. Under rent stabilization, landlords get regular rent increases that keep up with inflation and they maintain the property and choose the next tenant as they always have. They just can't push people out of their rented homes to get extra profits as long as the tenant can afford to continue to pay the same rent (adjusted for inflation) that they paid when they moved in.

III. Rent Stabilization and Just Cause for Eviction protect tenants from displacement

Rent Stabilization gives tenants stability in their homes. Critics say this reduces mobility and makes the rental market inefficient. Stability is a virtue for homeowners and tenants alike, allowing people to remain close to family and friends. We don't argue that retired homeowners should be forced out so higher income people can have a wider choice of places to buy. Renters deserve equal consideration. A long-term tenant's rent will be lower than a new tenant's rent, just as a long-term homeowner's payments are lower than for the person who just bought.

IV. Rent Stabilization has no effect on development of new housing.

Rent stabilization has no effect on new construction. This finding is well-supported by the studies reported in the academic literature. Initial rents will be whatever the market will bear at the time of initial occupancy and State law provides an exemption for new construction.

V. New housing development will not stabilize the market in the foreseeable future

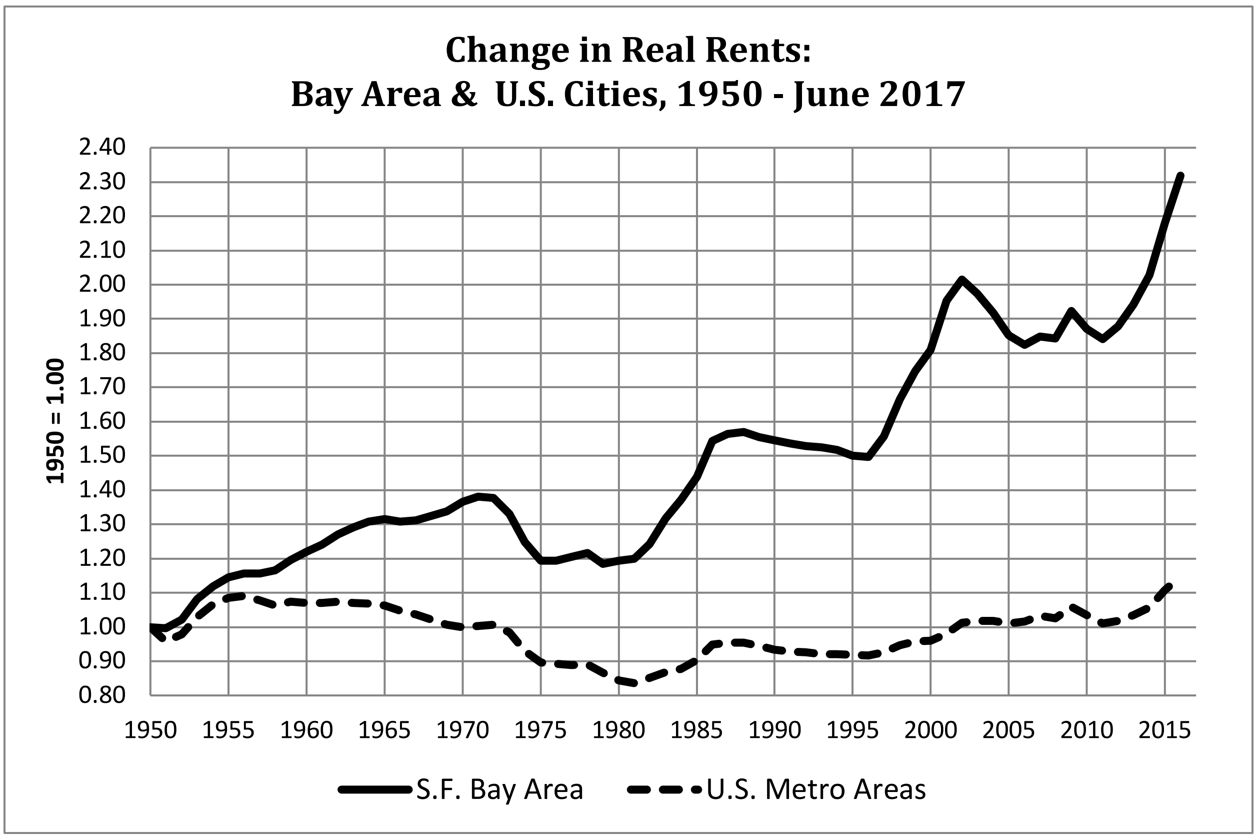
New construction has limited ability to prevent rapid rent increases because it is inherently slow and expensive. Most tenants can only afford to live in older rentals where the construction costs have already been paid off, which means "new construction" only becomes affordable to them in twenty or thirty years. New construction is self-limiting, since when rent increases slow down, so does new construction.

VI. Rent Stabilization does not reduce maintenance

A 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 little choice, landlords can often get higher profits with a lower level of maintenance. Rent Stabilization and Just Cause for Eviction protects tenants from retaliation when they call code enforcement to enforce their right to properly maintained housing.

3. The Problem: Real (Inflation-Adjusted) Rent, 1950 – 2017

As shown in the chart below, the San Francisco Bay Area is now in its third wave of massive rent increases since 1980. The result is tremendous hardship for tenants, particularly those with lower incomes. Each wave has increased rents still further above the level actually necessary to profitably operate and maintain rental housing. The average landlord in the rest of the U.S. is able to operate profitably with rents that are half of what is charged in the Bay Area.



Source: U.S. Bureau of Labor Statistics, Consumer Price Index, San Francisco Bay Area, All Metro Areas
(Chart shows the increase in Residential Rent divided by the increase in All-Items Less Shelter: When rents increase at the same rate as all other items, the line is flat. When rents increase faster than all other items, the line rises.)

4. *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.

5. *Limiting Unreasonable Rent Increases*

Rent stabilization provides stability by limiting "unreasonable" rent increases, so what makes a rent "reasonable" or "unreasonable"? In a properly functioning, fully competitive market, competition between landlords holds down the rent to the minimum necessary to profitably operate and maintain rental housing. A fully 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 fully 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". Under moderate rent stabilization programs, with annual inflation adjustments and vacancy decontrol, 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.

6. *New Construction Alone is Not Sufficient*

There are several major reasons why the rental housing market is not adequately competitive. 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, 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.

Rental housing is owned by tens of thousands of different investors and investment companies. This gives the appearance of competition. But when demand for rental housing increases, the ability of the market to respond with increased supply is severely constrained. New construction helps absorb some of the increased demand for housing in the Bay Area, but for the foreseeable future it will not be sufficient to restore affordability. (See chart of real rents, 1950 – 2017). Various studies have indicated that the Bay Area would need to increase its total housing stock by one-third in order to restore affordability to a "normal" level. It would take at least a generation to add that much housing even without the constraints of profitability, regulatory barriers and capacity within the construction industry.

7. Windfall Profits in Real Estate

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". When demand for a location increases it generates windfall profits for real estate investors because building owners can get much higher rents with only low-cost cosmetic improvements.

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 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. That 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.

8. Rent Stabilization Has 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.

9. Rent Stabilization Encourages Maintenance

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 which assumes that perfect competition has already reduced rents to the minimum compatible with operation and maintenance of the housing. 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 landlords cannot profitably operate and maintain 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.

10. Rent Stabilization & Code Enforcement Discourage Speculation

No matter how high rents go, there are always some real estate investors complain that they are not making money on their investment and claim they need higher rents in order to maintain the property. If the city has rent stabilization they blame rent stabilization. If the city is considering rent stabilization, they warn against it. The problem is not rent stabilization, but rather that they paid too much for the property. 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 excessive rent increases to compensate for failure to accurately estimate a property's operating and maintenance costs or for overestimating future rent increases or for taking on too large a mortgage to buy a property. In economics this is called "the winner's curse", because investors with overly optimistic assumptions will outbid more realistic investors to win ownership of an investment property.

Rent stabilization and code enforcement reduce such behavior, but do not eliminate it. The presence of rent stabilization often results in prospective buyers being more careful in analyzing rental property. In addition, better code enforcement reduces the extent to which new investors overpay for rental property based on an income inflated by under-maintenance.

11. 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 the San Francisco Bay Area. 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 City suffering from reduced property values and abandonment, ignoring the fact that many other cities without rent controls were also suffering the same problems, and they predicted a similar grim future for California if the ordinances were passed. After nearly forty years of rent stabilization, anyone see that San Francisco and Berkeley and New York, 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.

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 provide tenants with stable rents and slow the rate at which rents increase, but they do not hold down rents permanently and do 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 of both of market-rate and affordable below-market rate housing, to provide ongoing rent subsidies for the very poor, who cannot afford to pay a rent sufficient to cover operating and maintenance expenses, and to 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 predictable housing costs and stability in their homes.

12. 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, its history generally and in 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 are specified, including its scope and administrative and enforcement mechanisms.

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 and that rent stabilization can improve maintenance.

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.

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 unearned land rent is a major component of Bay Area rents.

13. 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, chapters and professional reports on housing policy, housing economics, rent stabilization and 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 Co-Chair of the Committee for Safe and Affordable Homes.

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