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# RESIDENTIAL RENT CONTROLS

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## AN EVALUATION

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# BACKGROUND THEORY AND EMPIRICAL FINDINGS

## **HOW RENTS AND RENT MOVEMENTS PERFORM VITAL FUNCTIONS IN RENTAL HOUSING MARKETS**

Without rent controls, residential rents are the market prices of occupying rental housing units. In free enterprise societies such as the United States, rents perform several key economic functions. First, they compensate housing unit owners for the costs of providing shelter to tenants. Such costs are of two types: those necessary to build rental units and those necessary to operate rental units after they have been built. Building costs include the costs of acquiring land, building materials, labor, architectural services, and legal services; the cost of borrowing the money needed to finance the planning and building process (or the income sacrificed during that process if developers use their own money); and a normal profit to the building developer. Normal profit is also a true cost, because without it no developers would create additional rental housing units. Operating costs include property taxes; insurance; utilities such as heat, electricity, and water; management costs; decorating costs; maintenance and repairs; services such as trash removal; and a normal profit to the owner.

Rents are not just unearned residuals that accrue to the owners of the housing units concerned. Rather, rents cover the true costs of providing the housing services offered by each existing unit. If rents are not high enough to cover the costs of operating existing units at normal profits, owners may cut back on services, repairs, and maintenance, thereby lowering the quality—and, in effect, the quantity—of the existing housing stock. Thus, adequate rents are essential to maintaining the existing stock of rental housing.

Secondly, rents signal developers, investors, and owners when to change the amount of resources invested in each specific housing market over time. The demand for rental housing in a local market can change much faster than the supply, because tenants are much more mobile than the physical capital required to build rental structures. It takes time to plan and build additional rental units. When demand suddenly rises, supply cannot follow as quickly. As a result, competition among tenants for the limited supply of units drives rents up to the short-run market-clearing level. That price level is high enough to reduce the number of tenants seeking rental units to exactly the number of units available at that price.

Typically, this increased rent does not immediately prevail for all rental units in the market. Rather, it applies chiefly to those units that become vacant and are rented again when demand quickens and to new units rented for the first time. Rents for units that remain occupied by the same tenants are slower to rise to the market-clearing level. Owners tend to hold down rent increases on these units to avoid losing good tenants. Nevertheless, increased rent levels quickly prevail at the margin of the market.

Owners of existing units who raise rents to the new level realize substantial profits. The chance of earning similar profits will soon cause developers to build additional rental units nearby if local zoning regulations permit. If the area has little vacant land, developers may even buy single-family houses, demolish them, and build higher-density rental units on their sites. As long as rents remain above this minimum supply-evoking level or are anticipated to rise above that level in the near future, developers will continue building. The total housing supply will then increase faster than total demand, unless demand continues growing at a very rapid rate, which is unusual.

Eventually, increased competition among owners for tenants will cause rents at the margin to stop rising and perhaps even decline. Rents at the margin will arrive at a level that again produces normal profits for owners but falls below the minimum supply-evoking level for developers. As a result, new construction will come to a halt, and the supply of and demand for rental units in that market will reach equilibrium. In this manner, rapid increases in rents or high levels of rents at the margin of the market signal developers and investors that more resources should be invested in rental housing in that area.

If the demand for rental units in an area declines, an excess of space is created. Competition among owners for tenants will then cause rents at the margin to fall below the level needed to produce normal profits. Developers will stop building units, and owners of some units may even take them off the market. They may convert units to other uses, demolish them, or put them up for sale (about one-third of all rental units in the United States are single-family dwellings that could also be owner-occupied). Thus, rents at the margin below the level needed to produce normal profits signal developers and investors that too many resources are already at work.<sup>4</sup>

What are normal profits? For developers, they are profits just large enough to motivate them to build a sufficient number of units to replace those units wearing out and being removed from the market each year. For owners of existing units, normal profits are those just large enough to encourage them to maintain their units in good condition, but not necessarily rehabilitate them. The exact rate of profit on invested capital considered normal at any given moment depends upon what rate can be earned from alternative sources such as corporate bonds, U.S. Treasury securities, and stocks. When interest rates in general rise, the normal profit rate on rental units also rises; when interest rates fall, so does the normal profit rate. However, the normal profit rates on rental units for both developers and owners are usually notably higher than Treasury or corporate bond rates, because rental units require far more management effort and incur greater risk of default than such bonds.

For the signaling function of residential rents to work, at least some owners must temporarily earn higher than normal profits immediately after a surge in demand or anticipate doing so in the near future, and some owners must temporarily earn inadequate profits immediately after a drop in demand. It is precisely the existence of such unusual profits that attracts developers into building additional rental units. The problem of unusually high rents stimulates its own solution in the form of additional supply. If rents were prevented from rising under such circumstances so that owners would not earn unusually high profits, no signals would be sent to developers to create more units. The basic problem of inadequate supply would not be remedied, because the market would not respond to greater demand by producing greater supply.

Conversely, if demand suddenly falls and rents at the margin follow, owners will earn less than normal profits—which can be considered inadequate profits. It is harder for owners to remove capital from the market than to add it, but they nevertheless can do so over time. They can convert rental units to other units, demolish them, sell them, or let them deteriorate. The last tactic will not occur if the local government strictly enforces its building codes. But deteriorating properties are a frequent consequence of rent levels below those that produce normal profits.

This analysis shows that it is vital for the efficient long-run operation of rental housing markets to permit rents at the margin of the market to rise and fall with the current balance of supply and demand. If that happens, rents can send effective signals to developers, investors, and owners concerning whether to build additional rental units or to remove existing ones from the market. If controls prevent rents from rising in response

<sup>4</sup>Rents can also fall below that level in real terms (taking account of inflation) even when they are stable or rising in nominal terms (current dollars). Thus, if rents rise 5 percent when the general price level is going up 10 percent, the real rent level has fallen 4.5 percent. This situation of rising nominal rents but falling real rents, on the average, prevailed during much of the period from 1960 to 1980. See Anthony Downs, *Rental Housing in the 1980s* (Washington, D.C.: The Brookings Institution, 1983), pp. 27-42.

<sup>5</sup>This situation is not changed by the presence of nonprofit developers in the market. Even nonprofit developers must cover all the costs of building new units—including a return on capital paid to those people who supply the money required. Such developers will not be motivated to build additional units in a market unless rents are high enough to cover all their costs. True, their costs may be somewhat lower because they do not make profits, but experience shows that their incentive to control costs is weaker than that of profit-making developers. Members of nonprofit firms cannot personally retain any savings they make from cost reductions, as can the owners and often the key employees of profit-making firms. Hence, in total, the costs of building new units incurred by nonprofit developers are not significantly lower than those incurred by profit-making developers. And both types of developers need the signals of movements in rent levels to tell them when and where it is desirable to build additional new units or to cut back on the operation of existing units.

to increases in demand, no signals are sent to developers to build more units, and no incentives are created for them to do so. Then few, if any, additions to supply will take place, and the imbalance caused by the initial rise in demand will not be remedied.<sup>5</sup>

Two key assumptions underlie the preceding analysis. The first holds that strong competition exists among owners of existing rental units, among potential developers of additional units, and among tenants. The second states that developers can enter the market freely and build more new rental units if they so choose. When such conditions prevail, movements of rents effectively signal—and call forth—changes in resource allocation that are both socially desirable and efficient.

## RENT CONTROLS DURING WARTIME

Demands for rent control tend to arise when either strong competition on the supply side of the market (that is, among owners and developers) or relatively free entry of additional units is absent. Historically, these conditions first prevailed during wartime when a rapid increase in the demand for rental units combined with prohibitions against building any new units. Especially in World War II, demand for rental units in many U.S. metropolitan areas soared. Thousands of new workers were imported from rural areas to work in defense plants and earned high wages. They needed rental units and could pay well to secure them. But to save materials for war production, building new rental units was prohibited in most areas.

Wartime conditions put the owners of existing units in a monopolistic position. Many potential and existing tenants were bidding against each other to occupy the existing units, without any prospect of adding new units to meet the increased demand. The market-clearing price was at a much higher rent level than initially prevailed. If rents had been allowed to rise to that level, they would have soared tremendously, and rental unit owners would have earned unusually high profits, far above those needed under normal conditions to trigger additional supply. But those high rents could not perform their usual signaling function of evoking additional supply. Instead, higher rents would simply have transferred resources from tenants to owners, and not just temporarily, but as long as the building of new units was prohibited.

Most observers—including the author—would regard wartime conditions as appropriate circumstances for government intervention in the market. Without rent controls, owners would be able to profit from the prohibition on additional building by charging tenants unusually high rents. For this reason, most societies that prohibit building new housing during wartime or other emergencies also create rent controls to protect tenants from exploitation. Residential rent controls are socially justifiable under such conditions.

The fundamental benefit of rent controls is to prevent owners who enjoy monopolistic market positions from taking unfair advantage of tenants. That protection consists of holding rents below the levels they would reach if allowed to rise to market-clearing prices. The size of the benefit to tenants is equivalent to the difference between the market-clearing prices and the controlled rents. By preventing owners from raising rents by that amount, rent controls essentially add that amount to the purchasing power tenants can use to buy other goods and services. Rent controls prevent a potential loss of income to tenants and a potential increase in income for owners—"potential" because owners do not actually raise rents to their market-clearing level and then rebate the difference to the tenants. From the viewpoints of both parties, these benefits and costs are real, even though they involve potential rather than actual sums.

Historically, rent controls have become reasonable public policy when two conditions both occurred simultaneously and were expected to persist for a substantial period. Those conditions are a sizable increase in the demand for rental units in a housing market and a prohibition against the development of additional new rental housing units because of the need to conserve resources for some other overriding social purpose.

The second condition is more important. If demand rises sharply, but without blocked entry to new supply, then it is a mistake from the viewpoint of society as a whole to keep rents from rising. Higher rents will call forth additional supply, which is precisely what is necessary to deal effectively with the higher demand in the long run. Rent levels high

enough to cause unusually high profits will be only temporary, lasting only until more supply can appear.

Moreover, if either of the two conditions that sometimes justifies rent controls is not expected to last long, rent controls are probably not warranted. If the surge in housing demand is clearly temporary, as was the case in Alaska during construction of the Alaska pipeline, it is probably not worth the administrative costs and effort to establish a full-fledged rent control system.<sup>6</sup> Most owners will not raise their rents to exploitative levels anyway, because they prefer to retain their initial good tenants who are likely to remain after the demand surge is over.<sup>7</sup> Similarly, if the blocked entry is temporary, it is also not worthwhile implementing a complete rent control system and then dismantling it when entry is possible again, particularly given the difficulties of repealing a rent control system once put into place.

## RENT CONTROLS IN RESPONSE TO RAPID GENERAL INFLATION

Rent controls also have been adopted during peacetime, even though the two basic conditions described as justifying them are usually absent. In fact, most American cities that now have rent controls adopted them in response to peacetime periods of rapid inflation. When consumer prices in general rose swiftly during the 1970s, tenants in many communities called for adoption of rent controls to help them cope with their declining real purchasing power. Their rents were rising rapidly, especially when they included utility costs—also soaring.

Rents, however, were not increasing any faster than the prices of many other necessities of life. Moreover, neither of the two basic conditions described earlier as necessary to justify rent controls was present. Overall rental housing demand had not escalated, though it was gradually increasing over time. Nor was there any legal prohibition against building new rental housing. Nevertheless, political pressure to adopt rent control mounted, especially in communities where most residents were renters.

The building industry could not respond to these new higher rents immediately. It takes time to construct new units, especially in cities that are already fully developed. Thus, highly visible increases in rents did not immediately call forth enough additional supply to dampen those increases quickly. At the same time, the real purchasing power of nearly all households was being eroded as incomes rose more slowly than prices in general.

Local elected officials in some communities responded to the situation by adopting rent controls, in spite of the many drawbacks of controls described later in this study. These officials wanted to appear to be "doing something" in the short run to help their constituents. They could not pass local price controls on food, energy, clothing, automobiles, or any other components of normal consumption, even though the prices of those items were soaring too. For example, if a community adopted local price controls on gasoline, oil companies would simply stop supplying that community and sell their gasoline at higher prices in nearby communities where no controls existed. But housing is not mobile; owners placed under rent controls cannot move their units to some other uncontrolled area. As a result, owners of rental units became the victims of a combination of the immobility of real property and the desire of local politicians to demonstrate their sympathy for constituents suffering from general inflation.

Rent controls adopted under these conditions represent an attempt to combat poverty or other economic distress by redistributing income from owners to tenants. During the 1970s, however, most people living in the units then placed under controls were not poor. Such controls are therefore subject to several objections as described later.

Nevertheless, adopting rent controls during a period of rapid inflation clearly provides short-run benefits to nearly all renters, from the poorest to the wealthiest. Controls usually prevent owners from raising rents as fast as their operating costs rise, especially during periods of particularly rapid inflation. Controls thus reduce the erosion of household real incomes and purchasing power that normally accompanies such inflation, even though neither of the two conditions cited above as socially justifying rent controls is usually present during such inflationary periods.

<sup>6</sup>During the pipeline construction period, Alaska enacted a law limiting permissible rent increases and providing for a complaint system, but did not register all rental units or otherwise create a full-scale rent control system.

<sup>7</sup>In most rental markets, most landlords are small-scale operators who own and rent out relatively small numbers of units. They tend to act more as turnover-minimizers rather than rent-maximizers because of the high cost of losing the income from and renting out a unit that becomes vacant. They seek out good tenants who pay on time and treat their properties well and try to retain such tenants once they have moved in. This actually causes rents for tenants long-established in their present units to lag behind the market in general. See Downs, *Rental Housing in the 1980s*, pp. 34–35.

Does using rent controls to respond to inflation represent sound policy? The answer depends partly upon how rapid the rate of inflation and how long the inflationary episode is likely to last. The greater the inflation, the greater is the justification for adopting rent controls. If high inflationary pressures are not expected to last long, the administrative costs of setting up rent controls may far outweigh any benefits. Nonetheless, the longer controls remain in place, the more they distort efficient allocations of resources, even if adopted during periods of inflation expected to last a long time. Moreover, once controls are adopted, it is politically difficult to repeal them in order to avoid their long-run costs, a difficulty that grows greater the longer controls remain in force. Finally, the benefits and costs of any set of rent controls depend enormously upon exactly how the control ordinance works. All of these points are dealt with later.

<sup>8</sup>Many data in this section were taken from Daniel O'Connor, *Rent Control in the United States: A Declining Phenomenon* (Emeryville, California: Johnstown Institutional Advisors, Inc., 1987).

## THE CURRENT EXTENT AND ORIGIN OF RENT CONTROLS<sup>8</sup>

As of 1986, more than 200 communities in the United States had implemented some form of residential rent controls. All but one were located in the five states of New York, New Jersey (which contains over half of all rent-controlled localities), Massachusetts, Connecticut, and California. The other jurisdiction is the District of Columbia. Several other countries have adopted rent controls for extended periods, including the United Kingdom and France, which have had controls since World War I. However, this analysis will concentrate on U.S. experience.

Rent controls first appeared in the United States during World War I. Limited to a few communities that had experienced severe housing shortages, they were gradually phased out after the war. During World War II, the federal government adopted nationwide rent controls as part of its general price control program. Therefore, all communities were under such controls from 1942 through about 1949. However, these controls were rapidly dismantled thereafter. By the mid-1950s, New York was the only state that retained rent controls.

No other area in the United States came under rent controls until the relatively rapid inflation of the 1970s. The inflation was caused primarily by two worldwide oil price explosions in 1973 and 1979, subsequent to an escalation of domestic prices in the late 1960s related to the Viet Nam conflict. In 1971, the federal government imposed a 90-day price, wage, and rent freeze followed by a flexible price stabilization phase that lasted until January 1973.<sup>9</sup> Several cities in the Northeast adopted rent controls in 1973 and 1974, and many more did so between 1978 and 1980. Few communities have enacted rent controls since then. In fact, as of mid-1988, 14 states have passed laws or have constitutional provisions prohibiting their localities from adopting rent controls.

<sup>9</sup>The federal program is briefly described in George Sternlieb, Monica Lett, and others, *Rent Control in Fort Lee, New Jersey* (New Brunswick: Rutgers University, Center for Urban Policy Research, May 1975). This is an unpublished document.

Because housing is a major user of energy, rapid escalations in energy prices greatly increased rental housing operating costs during the 1970s when energy prices rose faster than the overall price level. Owners naturally tried to raise rents to recover those higher costs. Local governments could not prevent increases in the costs of most components of consumer budgets during this rapid general inflation. But because of the immobility of rental property, governments could at least slow increases in residential rents. In response to political pressure from tenants, many communities adopted rent controls.

Several of the communities that have adopted rent controls share certain traits, including a high proportion of renters in their overall populations, a relatively high proportion of college and university students in their overall populations, relatively low rental vacancy rates when controls were adopted, and strong barriers to the creation of additional rental units within their boundaries, such as restrictive multifamily zoning and shortages of vacant land. Based upon past experience, other communities with these traits are probably the most likely to adopt rent controls if another round of high general inflation is triggered in the future.

<sup>10</sup>This section relies heavily upon data taken from O'Connor, *Rent Control in the United States*.

## VARIATIONS IN RENT CONTROL REGULATIONS<sup>10</sup>

It is important to recognize that not all rent control ordinances are alike, so the impact of a particular ordinance upon local housing markets will depend greatly upon its specific characteristics. The many forms that rent controls take across the country fall

along a spectrum. Controls range from ordinances that severely limit rent increases and otherwise impair normal market operations, thereby restricting the owners' return on investments, to ordinances that do not do so. The economic dislocations caused by particular provisions are largely a function of their stringency.

Rather than evaluating where most specific rent control ordinances fall along the spectrum, this study identifies two general types of rent control laws, one representative of stringent rent controls and the other of temperate controls. Such a distinction is essential to reconcile the apparently conflicting empirical studies that have been performed to date on the economic implications of particular rent control ordinances.

Seven key characteristics are important in determining whether a particular rent control ordinance is closer in character to the stringent rent control category or the temperate rent control category. These factors include:

- **General exemptions.** Most rent control laws exempt some rental units from controls, usually those in structures containing only a few units or those held by persons owning just a few units.
  - Stringent ordinances exempt very few units.
  - Temperate ordinances tend to exempt much larger classes of units.
- **Exemptions for new construction.** Almost all existing rent control laws exempt from controls all units built after some particular date, no later than when the laws were passed.
  - Stringent ordinances have a history of violating their own past exemptions (as New York City has done twice) by later placing new units under controls.
  - Temperate ordinances are found in cities that have never violated their own exemptions; hence their exemptions for new construction sometimes—but not always—have greater credibility with developers and investors.
- **Vacancy decontrol.** Many ordinances permit owners to raise rents to current market levels whenever a unit is voluntarily vacated by its initial tenant.
  - Stringent ordinances either do not permit such vacancy decontrol or cap the amount by which the rent can then be raised. If they do allow rents on vacated units to rise to market levels, they also place those units back under controls within a relatively short period.
  - Temperate ordinances permit rent increases to reach current market levels; some never put those units back under controls but others do.
- **Provisions for determining allowable rent increases.** Nearly every control law permits some base rate percentage increase in rents every year, presumably to offset increasing operating costs in the steadily inflating U.S. economy. Two important variables are the specific body that sets the increase and the manner of calculation.
  - Stringent ordinances give responsibility for rate increase decisions to separate rent boards and provide great discretion about the outcome. Such boards tend to be highly sympathetic toward tenants. Stringent ordinances often keep the base rent increase lower than the overall rate of inflation by indexing the increase to some fraction of the rate of increase in the overall Consumer Price Index.
  - Temperate ordinances describe the method of calculation in detail within the ordinance itself or are vague about the method but permit the city council to make the decision. They also permit rents to keep pace with the overall inflation rate, usually by setting the base percentage increase equal to that of the Consumer Price Index. They try to permit owners of rental units to earn a reasonably competitive rate of return on their investments.
- **Passing through costs of capital improvements.** Whenever owners spend money upgrading, rehabilitating, renovating, or repairing a unit, they would naturally like to earn a return on that investment by raising rents. All control laws have some provisions to accommodate capital improvements.
  - Stringent ordinances require owners to petition for and tenants to approve such increases in advance (but tenant approval is necessary only for improvements to their own units, not to an entire building). Rent boards in such cities turn down a high proportion of such petitions. They also require the computation of the permitted recapture rent increases by amortizing the costs over long time periods, up to 15 years.

- Temperate ordinances usually do not require owners to petition for increases after making an improvement or to obtain permission from the tenants. If cities require petitions, they approve a high proportion. They also use relatively short periods for recapture of the investment, sometimes three to four but mostly five years.
- Passing through hardship expenses. All ordinances permit some process of owner relief for extraordinary operating expenses or for situations in which owners are not earning competitive returns on their investments. All require owners to petition for such relief. Four key elements are what conditions constitute a valid hardship, what formula is used to determine the resulting rent adjustment, whether property financing arrangements are taken into consideration, and what proportion of hardship requests actually is approved.
  - Stringent ordinances tie requests to whether owners are earning the same return on investment as occurred during some designated base year, often the year before the enactment of the rent controls. Cities ignore debt financing in calculating rates of return and turn down most requests.
  - Temperate ordinances permit owners to earn some target rate of return on investment, from 9 percent to 12 percent, or allow hardship applications if net income has fallen for two years. They take debt financing terms into account in computing overall profit rates and approve most requests.
- Condominium conversion restrictions. Most rent control laws impose at least some restrictions upon owners' ability to remove their units from controls by converting them to condominiums. Almost all require owners to provide substantial notice to tenants of proposed conversion, and many prohibit conversion unless some proportion of tenants approves.
  - Stringent ordinances forbid the eviction of any tenants to carry out conversions, require a high percentage of all tenants to approve the conversion in advance, require owners to pay sizable relocation compensation to tenants who must move, may even require units to be owner-occupied for several years before they can be converted, and limit the total number of units within the city that can be converted in any one year.
  - Temperate ordinances allow evictions for conversion if some low percentage of tenants approves conversion, do not require payment of relocation allowances or mandate only modest allowances, and place no limit on the total number of units within the city that can be converted in any period.

Clearly, many combinations and variations of stringent and temperate traits can exist among, and even within, particular ordinances. Nevertheless, it is possible to reach a comprehensive judgment, admittedly subjective, on the relative degree of stringency embodied in a particular ordinance. For example, as of 1988, Santa Monica, California, probably has the most stringent rent control ordinance in the United States, while its neighbor, Los Angeles, has one of the more temperate ordinances. As used in this study, the term stringent rent controls generally means ordinances that greatly restrict the owners' ability to raise rents annually, to pass through operating expense increases or rehabilitation costs to tenants, and to remove units from controls through vacancy decontrol, conversion to condominiums, demolition, or shifts to nonresidential uses. These restrictions tend to reduce owners' returns on their investments to below-competitive levels. The term temperate rent controls generally means ordinances that do not embody such severe restrictions and therefore permit owners to maintain competitive returns on their investments; that is, yields comparable to returns from other investments with similar degrees of risk.

As discussed further, the empirical evidence regarding the effects of rent controls on housing markets varies tremendously, depending upon which of two types of controls is involved. For most factors, the adverse consequences of temperate controls appear to be limited—mainly because those ordinances do not substantially impair the operation of the housing market. In contrast, the empirical evidence appears to support the general theory regarding the serious harm that stringent rent controls can impose on a housing market over time.



## QUALIFICATIONS TO THE USE OF RENT CONTROLS

Several important qualifications apply to the use of rent controls, even under the two key conditions described as socially justifying such controls. First, adopting rent controls does not necessarily eliminate the gap between the market-clearing prices of housing units and the lower prices that owners are legally permitted to charge. Under stringent rent controls, the rental housing market cannot reach equilibrium. Since a lack of units cannot satisfy demand at the controlled price, demand and supply at that price remain out of balance. If the rent control ordinance does not permit vacancy decontrol, the remaining excess demand at the controlled price level generates pressure to use other means of rationing the limited supply of units among tenants. Many households double up such that either the initial tenant or the owner earns extra income by permitting two or more households to share a single unit. Either tenants about to vacate a unit or the owner may charge another household for key money in return for allotting the unit to that household through a sublease or some other arrangement.

These supplemental rationing devices are far less prevalent in temperate rent control systems that permit relatively unconstrained vacancy decontrol, especially if the population in the area concerned is mobile. Under such systems, a large number of rental units are repriced each year at the rent levels established by current market demand. The repricing greatly reduces the average gap between actual rents and market-clearing rents in the market as a whole, thereby decreasing the imbalance between supply and demand at the average rent level (including both units repriced at market rents and units with rents still at originally controlled levels).

The second qualification is that the gap between market-clearing rents and controlled rents under stringent control programs tends to widen over time, particularly in inflationary economies. General price levels rise continually over time in nominal terms (that is, in current dollars), but rents are controlled in nominal prices. As a result, controlled rents tend to lag behind what they would be if properly adjusted to allow for inflation. The lag is especially likely to occur if controlled rent levels are set by a politically appointed body rather than tied to a formula linked to the general price level.<sup>11</sup> But the nominal rent level necessary to call forth additional rental housing production (if so permitted) rises along with the general price level. Hence the gap between the market-clearing price and controlled rents expands over time under stringent rent control ordinances.

As noted above, the second qualification does not necessarily apply under temperate control ordinances that permit relatively unconstrained vacancy decontrol. With unconstrained vacancy decontrol, the gap may remain both low and unchanged over long periods, provided the renter population is relatively mobile. (If the population were not, few units would ever become decontrolled because so few people would move and leave units vacant.)

This analysis implies that the longer stringent rent controls remain in place, the larger the gap between controlled rents and market-clearing rents and, therefore, the greater the sudden increase in rents if such controls were removed all at once. When controls have been in place a long time, the gap between the controlled level of rents and both the short-run market-clearing level and the minimum supply-evoking level can be large. The Rand Corporation estimated that, in New York City in 1968, the average tenant in a rent-controlled unit would have had a rent increase of 57 percent if the actual controlled rent rose to the estimated market rent.<sup>12</sup>

If stringent controls are suddenly removed, rents may rise dramatically and soar from the controlled level to the short-run market-clearing level. If the latter is above the minimum supply-evoking level, then developers will soon start building additional units—assuming local zoning laws allow them to do so. As more and more new units come on the market, supply should expand faster than demand and drive rents at the margin of the market somewhat downward. Rents will keep falling until they reach the minimum supply-evoking level. Then developers will stop building more new units as the market reaches rough equilibrium. But rents will nevertheless remain well above the initial controlled level.

<sup>11</sup>Of course, formulas that permit rents to rise only some fraction of the increase in the Consumer Price Index less than 1.0 also usually cause rents to lag behind operation costs, thereby reducing owners' profits (before owners seek to adjust by cutting maintenance).

<sup>12</sup>Joseph S. DeSalvo, *Reforming Rent Control in New York City: Analysis of Housing Expenditures and Market Rentals* (Santa Monica: The Rand Corporation, July 1971—P-4683) pp. 22-42. By contrast, the Rand Corporation estimated that the analogous gap in Los Angeles after 12 years of rent control under a temperate ordinance would be only about 3.5 percent. See C. Peter Rydell,

C. Lance Barnett, Carol E. Hillestad, Michael P. Murphy, Kevin Neels, and Robert H. Sims, *The Impact of Rent Control on the Los Angeles Housing Market* (Santa Monica: The Rand Corporation, August 1981, N-1747-LA), pp. 57-63.

This sequence of events may impose severe hardships on households whose rents rise far above their initial, controlled level. It may take a long time for new construction of many additional units to occur. Local elected officials are often reluctant to remove stringent rent controls when the gaps become large. They know that many of their renter constituents may face large rent increases—much larger than any likely accompanying wage increases—in the short run and perhaps even in the long run.

Naturally, such increases are unpopular with the tenants who must pay them. Tenants pressure elected officials to keep rent controls in force—even after the condition of blocked entry that necessitated those controls has abated. This is precisely what happened in New York City after World War II. The city electorate was dominated by tenants, not homeowners, and local officials succumbed to strong pressure to retain rent controls. That pressure has become even greater over time as the gap between market-clearing rents and controlled rents has grown. The adverse results of retaining controls over the long term are discussed later.

The long-term imposition of stringent controls has two policy implications. First, cities should eliminate or greatly moderate stringent rent controls as soon as possible after either of the two basic conditions justifying them abates. Doing so will permit an early return to an effective balance of supply and demand. U.S. cities that eliminated rent controls immediately after World War II do not have nearly as acute rental housing shortages as those that retained such controls for long periods thereafter.

Second, in markets where stringent rent controls have prevailed for a long time, cities should phase out controls gradually rather than eliminate them all at once. One phase-out strategy calls for decontrolling units as they become vacant, although a decontrol approach tends to decrease the mobility of some tenants who can lock in lower rents by remaining in their units. A phase-out tactic has drawbacks but will cushion the hardships that would otherwise occur from instantly moving rents from controlled levels to the short-run market-clearing level.

Neither of these implications applies with nearly as much cogency to areas where temperate rent control ordinances prevail. The gap between actual rents and market-clearing rents may not have grown large in such areas, even if controls have been in force for a long time. For example, in Los Angeles, rents under controls rose an average of 10.9 percent per year (including utility costs) from 1978 to 1984. Uncontrolled rents in nearby communities rose an average of 11.1 percent per year in the same period.<sup>13</sup> If the latter represent market levels, they were only 1.2 percent higher than the former after six years of controls.

<sup>13</sup>Hamilton, Rabinovitz, Szanton, Alschuler, Inc., and The Urban Institute, *Rental Housing Study: The Rent Stabilization System—Impacts and Alternatives* (Los Angeles: City of Los Angeles Rent Stabilization Division, April 1985), p. ii.

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# ADVERSE EFFECTS OF RENT CONTROLS

This analysis of the principal costs or disadvantages associated with rent controls is generally consistent with other theoretical analyses of these costs and disadvantages, with one important exception. Many earlier analysts, assuming that all rent controls were stringent in character, conducted their analyses accordingly. In contrast, this study examines both stringent and temperate forms of rent controls.

The analysis of each adverse effect begins with a theoretical discussion and assumes a stringent ordinance prevails. The analysis then discusses the theoretical implications of a more temperate ordinance. Finally, in a separate section, an analysis of the available empirical evidence indicates in each case the extent to which the ordinance involved was a stringent or temperate rent control law.

## THE INHIBITION OF NEW RENTAL HOUSING CONSTRUCTION

### Theoretical Analysis

By preventing rents from rising to their short-term market-clearing level, stringent rent controls distort the resource-allocation signaling function of the price system. Specifically, stringent controls prevent owners from reaping the unusually high profits that would trigger the development of additional new rental units. Instead, owners often receive below-normal profits because controlled rents lag behind true total operating costs, including debt service. As a result, developers and investors are discouraged from building new rental units. This prevents the expansion of the overall rental housing supply needed to cope with the higher demand that stimulated rising rents.

In other words, stringent rent controls inhibit the development of the additional new rental units needed to remedy the problem that led to the adoption of controls. This self-defeating aspect of stringent rent controls is their most serious long-run drawback. The rapid increases in rents that usually stimulate adoption of any rent controls are invariably caused by an excess of demand in relation to the existing supply. The only long-run cure for that imbalance, other than cutting back on demand itself, is expanding the supply of available rental units. Expansion of the supply requires building new housing units (or converting other properties to use as rental housing). But stringent rent controls weaken or even destroy the incentives for developers to build new units by limiting the potential profitability of undertaking development.

Even stringent rent control ordinances often try to cope with this disadvantage by exempting newly built units from controls. In theory, the exemptions remove any disincentive to new development caused by the limited profits realized by owners of

existing units. But such exemptions have been relatively ineffective for two main reasons. First, existing rents are not permitted to rise to levels that would justify building new units. Therefore, developers cannot be sure that they will be able to charge rents sufficient to cover the full costs of new units plus a normal development profit. They need the persuasive signals of higher actual rents to be sure that is possible.

Second, and even more important, many developers and investors are skeptical about laws that exempt new units from rent controls. Many cities in the past have enacted such laws but then later placed supposedly exempt new units under controls. Since 1945, New York City, for example, has twice imposed controls on exempt units. No local legislative body can pass laws that definitively bind later decision makers. Accordingly, a developer or investor cannot be absolutely certain that what today's city council provides, tomorrow's will not take away.

In most cities with stringent rent controls, few new rental units have been built even when exempted. Both developers and investors say to themselves, "Why take a chance on investing several million dollars in a project, only to have some politician make it economically infeasible a few years from now?" Many major insurance companies will not make mortgage loans on rental housing projects in rent-controlled cities, no matter what exemption clauses exist in the ordinances. Exemptions obviously do not eliminate the strong disincentives that rent controls exert upon the building of new rental units.

A city with temperate rent controls that has never doubled crossed developers by placing once-exempt new units under controls some years after those units were built may not be viewed as skeptically by builders and investors as is New York City. If a city's rent control ordinance also permits owners of rental units to earn a reasonable return on their investment, developers and investors may be willing to build new units. Such has been the case in Los Angeles, at least from 1978 through mid-1988. Investors apparently believe they are doubly protected by the temperate nature of the Los Angeles rent control ordinance. It exempts from controls all new units built after 1978. Moreover, the nature of the controls it imposes even on existing units is so mild that owners of those units have not suffered economically.<sup>14</sup> Therefore, even if now-exempt new units are placed under controls at some later date, investors may believe that they will not suffer.

As a result of the development community's attitude, over 115,000 new rental units have been built in Los Angeles since rent controls were adopted in 1978. Because these new units are not under rent controls, the percentage of all rental units under controls is declining steadily over time. The growing disparity between rents for controlled and noncontrolled units may eventually pressure local politicians into placing some or all of the now-exempt units under controls.

Whether new construction of rental units would continue if such a double cross takes place cannot be reliably forecast. However, New York City's adoption of a double-cross strategy has drastically reduced the number of new rental units built there in recent years. But New York's rent control law is not nearly as temperate overall as the Los Angeles ordinance.

## Empirical Findings

The experience of the United Kingdom strikingly confirms that stringent rent controls reduce new construction of rental units in the long run. Stringent controls have prevailed in the United Kingdom from World War I to the present. In 1950, 53 percent of all occupied housing units were private rental units or rental units owned by private housing associations (not local housing authorities). By 1986, the share of all occupied units provided by those private sources had shrunk to 10 percent. Private owners furnished only 8.0 percent in England and 6.3 percent in Scotland. Thus, the share of all housing in the United Kingdom provided through privately owned rental units dropped by about 85 percent from 1950 to 1986.<sup>15</sup>

Almost all other empirical studies of the effect of rent controls upon new building of rental units involve temperate rent control ordinances. The author examined six such studies of U.S. experience since 1945 and several other studies dating from after 1970. Two were statistical studies conducted by the author while most were cross-sectional studies comparing rates of new rental construction in different sets of cities with and

<sup>14</sup>The Los Angeles rent control ordinance features only partial vacancy decontrol. Once rental units are voluntarily vacated by their occupants, owners can then raise the rent to whatever level the market will bear. However, once units become occupied at that rent, they come under the control system again. Owners can subsequently raise rents each year only by the generally permitted percentage, unless they make some unusual investment in improving the unit and obtain special permission for a larger rent increase. Such partial vacancy decontrol allows owners to set rents at full market levels only between tenancies. However, because of relatively high rates of tenant mobility in Los Angeles, such partial decontrol has had a less constraining impact upon the general level of rents than it would in communities with lower overall rates of tenant mobility.

<sup>15</sup>R.N. Chubb, *Position Paper: United Kingdom* (Paris: Organization for Economic Cooperation and Development, October 1987), Group on Urban Affairs, Project Group on Urban Land Markets, UP/L(87)28.

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without rent controls. Some of the studies used data from several cities across the United States; others compared more restrictive sets of cities within a single region, such as New Jersey or the Boston area. Some suffer from methodological problems that reduce the conclusiveness of their findings. However, none provides any persuasive evidence that temperate rent control ordinances inhibit the new construction of rental housing, an hypothesis that must be regarded as unproven.

## **OWNER UNDERINVESTMENT IN MAINTENANCE AND SERVICES**

### **Theoretical Analysis**

When residential rents are controlled, they often do not rise as fast as operating expenses. As a result, owners are likely to earn less than the normal rate of profit on their investment, particularly under stringent rent control ordinances. In response, owners may reduce their spending on maintenance and current services to make their net cash flow more nearly reflect the level of investment in their properties. The adjustment in operating outlays will cause a greater deterioration of rental property under rent controls than would prevail without controls.

The likelihood that owners' rate of return on investment will decline under rent controls is indicated by the levels of return supposedly permitted by major rent control systems. The yield on equity legally permissible in Washington, D.C., is 12 percent per year; in Newark, 9 percent; in New York, 8 percent. Except in Washington, these rates of return are lower than those normally earned on equity by real estate investors in markets unconstrained by rent controls. For example, current capitalization rates on free-and-clear office buildings in real estate markets, as of early 1988, almost all exceed 9 percent. Interest rates reported in the *New York Times* on February 25, 1988, were 8.37 percent for 30-year Treasury bonds—which have zero default risk—9.34 percent on telephone bonds, and 7.84 percent on federally tax-exempt municipal bonds. All these investments require no management effort whatsoever and have minimal default risk as compared to investing in rental housing. Such investments should pay far lower returns than equity invested in rental housing, but do not.

It is highly likely that owners of housing units under stringent rent controls will discover themselves earning less-than-competitive current yields on their equity investments. To make up for this deficiency, many will cut back on current spending for repairs, maintenance, modernization, and certain current services. They will reduce spending on current services and minor repairs first, since such reductions do not greatly decrease the long-run market value of their properties. But if their current net earnings decline low enough, owners may deliberately disinvest—that is, reduce their basic investment in their properties—to a level more commensurate with current earnings. They will then cut back spending on long-run maintenance and modernization. Units will then suffer from greater deterioration and obsolescence than would identical, noncontrolled units, resulting in decreased market values.

True, most rent control systems permit owners to pass some costs of repairs or renovation on to their tenants in the form of higher rents. But experience shows that rent control officials administering stringent systems rarely permit sufficient pass-throughs of such costs so that owners can earn fully competitive returns.

Furthermore, stringent rent controls make it hard to evict tenants who do not pay rent, damage the property, or otherwise conduct themselves in ways detrimental to the property or the neighborhood. (In many cities, it is difficult to evict such tenants even where no rent control exists.) Tenants are presumed to have a right of continued occupancy in the premises, unless owners can clearly prove sufficient wrongdoing to justify eviction. Proving wrongdoing is often difficult, costly, and time-consuming, requiring multiple hearings and testimony by neighbors reluctant to become involved.

In some cases, owners recognizing the futility of the eviction process simply abandon their units or whole buildings rather than maintaining properties under adverse circumstances. Before doing so, however, they may go through an extended period during which, in anticipation of abandonment, they try to collect rents but undertake no

repairs. This process causes rapid decay of properties and often their eventual removal from the rental market.

The abandonment of rental housing is a serious problem in some cities. Whole neighborhoods become filled with either derelict buildings or vacant lots where buildings once stood. Examples are the South Bronx in New York City, parts of Newark, and areas in Southeast Washington, D.C. Certainly abandonment is not limited to rent-controlled cities and is caused by factors other than rent control, but it is likely that rent control does contribute to abandonment.

When owners of rental units under stringent controls permit their structures to deteriorate, the quality of the existing rental housing stock also declines and eventually results in decreases in the quantity of that stock. Some units are removed from residential use, while others no longer provide the same level of housing services that they did when adequately maintained. Ironically, stringent rent controls actually reduce the supply of existing rental housing available over the long run. Rent controls produce unintended effects that aggravate the underlying relative shortage of rental housing that caused controls to be adopted in the first place.

In contrast, temperate rent controls are less damaging to the rental housing inventory if two conditions permit owners to earn reasonably competitive yields on investments in repairing, modernizing, and maintaining their properties. One is that rents in general are permitted to rise fast enough to cover current increases in operating costs, allowing owners to earn competitive yields on their initial investments. The second is that owners who need to make special added investments to cover large maintenance, repair, or modernization programs are also permitted to raise rents enough to earn competitive returns on these added investments.

Another relevant factor concerns trends in underlying land values in the community as a whole. If a community boasts a particularly attractive location within the metropolitan area and that area's overall population is growing in size and wealth, then the demand for land in that community may rise much faster than the average demand for land in the metropolitan area as a whole. Under such conditions, the market price of rental units in that community—including the land under the units—may be driven upward in spite of rent controls limiting the profitability of those units. As a result, the discounted total return from investing in such units, including appreciation from their eventual sale as well as their operating income, may be much higher than the current return from operating the rental units appears to justify.

Under such conditions, rapid land value appreciation can make up for relatively low current earning power imposed by rent controls, thereby permitting owners to maintain a competitive or better total yield on rental properties over time. Such an outcome assumes a temperate rent control ordinance that permits owners of rental properties either to make reasonable current operating profits or to shift their properties into nonrental residential uses. In contrast, stringent systems would prevent owners from realizing an operating profit, shifting properties to other uses, or taking advantage of land value appreciation as reflected in higher sales prices of rental apartment properties.

## Empirical Findings

The author examined seven empirical studies of the impact of rent controls upon owners' maintenance spending and upon tenants' perceptions of property condition. At least two dealt with relatively stringent controls and concluded that such controls definitely resulted in lower levels of maintenance than would have prevailed without controls. For example, the Census Bureau's 1987 survey of all rental properties in New York City showed that rental properties under both older rent control and newer rent stabilization were, on average, clearly in worse physical condition than decontrolled properties.<sup>16</sup> A Rand Corporation analysis of property maintenance in Los Angeles also concluded that the more stringent the form of rent controls used, the greater the resulting deterioration in the rental property inventory.<sup>17</sup>

In contrast, evidence concerning the effect of temperate rent control ordinances upon property maintenance is much more ambivalent. Some studies showed that owners spent less on maintenance after controls were adopted than before, while other studies contra-

<sup>16</sup>U.S. Bureau of the Census, Housing Division, *1987 New York City Housing and Vacancy Survey, Series IA*, pp. 113-125.

<sup>17</sup>Rydell and others, *Impact of Rent Control on the Los Angeles Housing Market*, pp. 57, 63. This study was based mainly

dicted this finding. In Los Angeles, although tenants perceived an increase in the percentage of properties needing repairs from 12.5 percent in 1977 (before controls) to 15.6 percent in 1984 (after controls had been in effect for six years), tenants in surrounding communities without rent controls perceived a 4.8 percent to 15.9 percent increase in the number of properties needing repair.<sup>18</sup> Altogether, no clear conclusion about the impacts of temperate rent controls upon owners' spending on maintenance and services can be derived from the existing evidence.

The negative impacts of lagging current rents upon owners' current rates of return can be partly or wholly offset by rapid increases in land prices that raise total rates of return, including appreciation at the time of sale. The effects of increasing land values in Los Angeles, especially in western portions, appear to have offset rent controls. Rental property appreciation throughout the city as revealed by actual sales has been substantial, according to the 1984 study by Hamilton, Rabinovitz, Szanton, and Alschuler and The Urban Institute.<sup>19</sup> The study estimated that rental unit property values increased 11.4 percent in 1983 alone and that the average annual (total) return on rental properties from 1977 through 1984 was 14.5 percent—mostly attributable to appreciation.<sup>20</sup> As a result, owners may not be motivated to reduce maintenance expenditures as much as would seem likely from consideration of current cash flows alone.

## REDUCED TENANT MOBILITY

### Theoretical Analysis

Rent controls motivate tenants to remain in their rent-controlled units long after they might have moved elsewhere. They remain for abnormally long periods for two reasons. One is to continue enjoying the below-market rents permitted by controls; if they moved elsewhere, they may not find other units with equivalent rents. The motivation to remain in place is especially powerful in rent control systems that feature vacancy decontrol. Such systems allow owners to reset their rents at any level the owners desire whenever the existing tenants living under controlled rents vacate. But as long as those initial tenants do not move, rents cannot be raised more than the percentage allowed each year by the rent control system. Since such permitted rent levels usually rise more slowly than true market rents, controlled rents tend to lag behind the rents owners charge when units are decontrolled. Any tenant moving from a controlled unit to a now-vacant—hence decontrolled—unit will probably have to pay more rent per quantity of comparable housing services received. This likelihood creates a powerful incentive for tenants in rent-controlled units to remain in place longer than they would otherwise. Empirical studies have verified that mobility rates are lower among rent-controlled tenants than among tenants not living under rent controls.<sup>21</sup>

Another reason tenants in controlled units exhibit low mobility is the difficulty of finding alternative rental accommodations in rent-controlled housing markets. Because rent control aggravates rather than remedies initial housing shortages, such shortages persist or worsen the longer controls are in effect. The demand for rental units at the controlled price level remains much greater than the supply. Whenever a controlled unit becomes available through death or a household move, an intense competition to gain occupancy of that unit is triggered. The competition is especially ferocious in rent control systems that do not permit vacancy decontrol. Rents in vacated units remain controlled at levels far below their true market rents and are bargains for tenants who can gain access to those units. Rent controls tend to lock in tenants in controlled units regardless of how suitable those units are to households' space needs. Controls prevent rational allocation of units among tenants in accordance with the intensity of tenants' preferences as measured by their willingness—and ability—to pay market rents.

### Empirical Findings

Stringent rent controls appear to reduce tenant mobility significantly, based upon the long average tenures of persons living in New York City's controlled units. The adoption

on model simulations, using models built from data on other cities, rather than on survey data from Los Angeles itself. This fact should be kept in mind when evaluating findings from the Rand study.

<sup>18</sup>Hamilton and others, *Rental Housing Study*, p. 20.

<sup>19</sup>Ibid., p. 104.

<sup>20</sup>Ibid., Exhibit 4-10, following p. 104.

<sup>21</sup>These studies are discussed in the Appendix.

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of temperate rent controls in Los Angeles was followed by a sharp decline in average tenant mobility, but a similar decline in tenant mobility occurred simultaneously in surrounding communities that did not have rent controls. On the other hand, the temperate rent control system in Los Angeles creates strong incentives for tenants not to move, because the benefits of rent control are much greater for tenants who remain in place than for those who move frequently. In fact, the latter appear to be losing from rent control, thereby subsidizing the former.

In summary, although only limited data concerning the impact of rent controls upon tenant mobility are available, they seem to confirm that such controls reduce tenant mobility at least somewhat, with greater reductions caused by more stringent controls.

## **USE OF NONPRICE DEVICES TO RATION SCARCE UNITS**

### **Theoretical Analysis**

The scramble to gain occupancy of vacated units generates additional means of rationing units, including key money, exorbitant brokerage fees, bribes to owners or subleasing tenants, and favoritism directed toward friends or relatives of either the initial occupant or the owner. The emergence of this quasi black market in access to vacant rental units is a second socially undesirable, microlevel misallocation of resources caused by rent controls.

### **Empirical Findings**

The literature revealed an absence of any reliable empirical studies of the hypothesis that rent controls generate nonrent devices for rationing access to available rental units. Only anecdotal evidence was available, although it tended to confirm the hypothesis.

## **ALLOCATION OF BENEFITS TO NONPOOR HOUSEHOLDS**

### **Theoretical Analysis**

Another microlevel inefficiency, and perhaps injustice, caused by rent controls is the distribution of benefits among different income classes of tenants. In theory, the most important social function of rent control is the protection of economically hard pressed households against exploitative increases in rents that, in turn, cause severe hardships. Logically, the most economically hard pressed renter households in every metropolitan area are those with the lowest incomes. But the majority of beneficiaries from rent control are moderate-, middle-, and upper-income renter households who benefit from rents lower than those that would prevail in the absence of controls. These households outnumber poorer beneficiaries in part because of their greater numbers in the overall population, even though the percentage of renters is much higher among poor households than nonpoor ones.

Furthermore, many very poor households do not receive effective protection from rent control systems. They rent on a month-to-month or week-to-week basis, without leases, paying cash in advance. They are highly mobile because in part many move when they cannot pay the rent. Many are immigrants who do not speak English well and cannot afford private legal representation. Many are also averse to dealing with government agencies because of negative experiences with welfare and police officials. As a result, very poor households are not likely to be well informed about how much owners can legally charge for rents or whether they can raise rents each year. (In Los Angeles, for example, 45 percent of all households in rent-controlled units in 1987 did not know whether their units were covered by controls.) Nor are they as likely as middle-income households to make use of the rent control complaint system.

This does not mean rent control provides no benefit to poor or moderate-income households; it does aid many of them, at least in the short run. But the greatest



beneficiaries, both in number and in absolute size of rental savings, are middle- and upper-income households. Many of them are able to occupy luxurious, near-downtown apartments at rents far below market levels—even renting more than one apartment in some instances. They are also in a position to use the rent control system to pressure owners to maintain those apartments. In contrast, the poorest households are far less able to prevent the controlled units they occupy from deteriorating because of inadequate owner investment.

### Empirical Findings

Several studies of rent control beneficiaries have been made, mainly concerning the New York City and Los Angeles rent control systems. Two clear conclusions are that rent controls benefit many low-income households and that middle- and upper-income households also receive a significant share of the total benefits from rent controls. In Los Angeles, for example, the Rand Corporation divided all households into three income groups: low, moderate, and high. About 48 percent of all households in rent-controlled units had low incomes (less than 80 percent of the area median), and 61.7 percent of all low-income households—both owner-occupants and renters—benefited from rent controls. In contrast, about 32 percent of all households in rent-controlled units had high incomes (more than 120 percent of the area median), and 34.2 percent of all high-income households benefited from rent controls. Rent controls served low-income households more fully than high-income ones, but still provided many benefits to the latter.<sup>22</sup> Edgar Olson's study of rent control benefits in New York came to the same conclusion.<sup>23</sup>

<sup>22</sup>Rydell and others, *Impact of Rent Control on the Los Angeles Housing Market*, p. 11-14.

<sup>23</sup>Edgar O. Olson, "An Econometric Model of Rent Control," *Journal of Political Economy* (November-December 1972), pp. 1081-1100.

## UNJUST COMPULSORY TRANSFER OF PRIVATE RESOURCES

### Theoretical Analysis

Whenever rent levels established by controls are below short-run market-clearing levels, rent controls compel owners of rental housing units to provide a financial subsidy to their tenants. Local ordinances force one group of private persons—owners—to transfer their potential resources to another group—tenants. (Resources are termed potential since owners never actually collect the rents foregone because of controls, nor do tenants actually pay those rents.)

In addition, owners of controlled rental units may also suffer an actual loss of resources when the controlled rents are not high enough to cover all actual operating expenses and provide a normal return on investment. Because increases in controlled rents often lag behind increases in operating costs, especially during periods of rapid inflation as in the late 1970s, owners of rent-controlled properties often experience reduced property values, especially under stringent control ordinances. As a result, owners in effect suffer from a capital tax on the market values of their properties.

Further, when rental housing is placed under controls, both lenders and equity investors demand higher yields to compensate for the greater risk of unprofitable operations. Higher yields mean the same income flows are capitalized at higher rates, resulting in lower market values. Thus, owners of rental units suffer a decline in market values even if the net operating incomes from their properties are not reduced.

Presumably, rent controls are adopted to serve a basic public purpose: the protection of tenants from experiencing unfair rent increases that would otherwise occur when the two fundamental conditions justifying rent controls exist simultaneously. As discussed earlier, when those two conditions do indeed exist and are likely to remain in effect for a considerable period, then rent controls are a relatively efficient means of meeting this public purpose. They are more efficient than the alternative of letting rents rise, taxing owners, and then paying direct subsidies to tenants.

However, as a general principle, it is undesirable for government to protect one private group against undue injury attributable to circumstances beyond its control by forcing another private group to transfer resources to the first one. If protection is indeed in the public interest, tax payers should pay for such protection through normal means of

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taxation. Reliance on rent controls comes perilously close—and may even amount to—a government taking of one group's resources to aid another group, without compensating the first group.

Many other subsidy arrangements that affect product prices have the effect of a taking. For example, establishing quotas on the import of foreign-made automobiles causes new automobile prices in general to be higher than they otherwise would be. American buyers of automobiles are then forced to pay more to both U.S. and foreign automobile manufacturers than they would in the absence of such quotas. The ostensible public purpose of aiding U.S. automobile manufacturers and workers is achieved by transferring resources from one group—automobile buyers—to another—automobile manufacturers.

However, not all consumers must buy new automobiles. They often have alternative means of transport available, including the purchase of used cars that largely escape this forced transfer process. In contrast, owners of rental housing units must rent them in order to gain any income from them whatsoever. Therefore, they are more compelled to transfer resources from themselves to tenants than are buyers of most subsidized or domestically protected products. The degree of compulsion inherent in rent controls at least partially differentiates them from many other subsidy arrangements, making rent controls even more socially undesirable.

Temperate rent controls can also redistribute resources among affected parties in a different way: by providing large benefits to tenants who do not move at the expense of those who do. This redistribution can occur if three conditions exist simultaneously. First, the rent control ordinance permits full vacancy decontrol of rents, but significantly restrains rents in units occupied by original tenants. Second, the overall mobility rate in the community is relatively high—that is, a large fraction of all tenants moves annually or at least frequently. Third, the community is experiencing a serious shortage of available vacant rental units as compared to the demand for them, even though a significant proportion of all rental units becomes vacant each year because of high tenant mobility. The last condition usually means that the population of the community is growing rapidly.

When these conditions all prevail, the shortage of available vacant units permits owners to charge premium rents for vacated units. Owners can obtain rents higher than those for comparable units in nearby communities. Further, these rents are even higher than owners would have received in the absence of rent controls. Rent controls aggravate the shortage of available units by encouraging many tenants to remain in place longer than they otherwise might. In contrast, owners receive discounted rents from tenants who do not move. With rent controls constraining owners to raise rents by only a legally limited amount each year, owners charge rents that are below the market-clearing level—that is, below both rents on comparable units in nearby communities and the rents obtainable if there had been no rent controls. The ability to obtain such discounted rents by not moving creates an incentive for tenants to remain in their units longer than they otherwise would have, thereby increasing the percentage of such stayers in the total renter population.

Since owners receive premium rents from frequent movers, but only discounted rents from long stayers, rent controls essentially transfer resources from the movers to the stayers, rather than just from owners to tenants. In fact, if the premiums received from the movers are large enough and movers represent a large enough proportion of all tenants, owners may not have to make net transfers of many of their own resources to tenants at all.

Of course, even if net transfers are not needed in the market as a whole, surely some individual owners must redistribute resources. For example, owners of rental buildings in which no tenants have moved since the inception of controls receive only discounted rents. Those owners make large transfers of potential resources to their tenants. In contrast, owners of other buildings in which annual tenant turnover averages over 50 percent may receive only premium rents and may be net beneficiaries of controls. However, it is most likely that all owners as a group still make net transfers of at least some resources to all tenants as a group, for reasons discussed earlier.

## Empirical Findings ✓

Several studies have investigated whether rent controls in fact hold rents below what they would have reached without controls. The universal conclusion is that rent controls do indeed keep rents measurably below levels they would have otherwise attained. However, the size of the resulting gap between actual, controlled rents and hypothetical, noncontrolled free market rents varies immensely with the type of control ordinance and the length of time it has been in effect.

The Rand Corporation estimated that 1968 rents under New York City's stringent ordinance averaged 57 percent below what they would have been without controls.<sup>24</sup> But Rand also estimated that 1990 rents under Los Angeles's temperate ordinance would average only 3.5 percent below what they would have been without controls.<sup>25</sup> This gap would be significantly higher if the Los Angeles ordinance were made more stringent. The small size of this gap also helps explain why Los Angeles has not experienced many of the adverse effects generally associated with more stringent rent control ordinances.

Ira Lowry estimated that owners of rental units under Berkeley's stringent ordinance experienced a real decline in net operating incomes of about 39.9 percent from 1978 through 1985.<sup>26</sup> Berkeley rent control authorities permitted only enough annual rent increases to allow owners to keep their net operating incomes constant in current dollar terms during a period when consumer prices rose 71 percent. Berkeley's policy caused a drastic decline in the real value of the income streams produced by the controlled properties—and presumably in their real market prices as well (their current prices stayed about constant). As a result, tenants paid rents that were about 25 percent below what they would have been if net operating incomes had kept pace with consumer prices generally. Clearly, Berkeley's rent control ordinance caused a massive transfer of economic resources from owners to tenants.

Another important empirical finding is that the total losses imposed upon owners by rent controls exceed the total benefits received by tenants. Edgar Olson estimated that New York's stringent rent controls provided tenants with only 52 percent of the losses imposed upon rental property owners.<sup>27</sup> The Rand Corporation estimated that tenants received benefits equaling about 89 percent of the costs imposed upon owners under the temperate Los Angeles ordinance. In Rand's estimations, tenant gains included reductions in rents that would otherwise have prevailed. But tenants also had losses consisting of rent control fees and more physical deterioration of their units than would have occurred without controls. Owners' costs were foregone rents they would have otherwise obtained, losses of units removed from use, and rent control fees. But owners also gained from making smaller maintenance expenditures.<sup>28</sup>

Another loss that rent controls impose upon owners is a smaller gain in the market values of their properties. A New Jersey study showed that assessed values of rental properties rose less in communities with temperate rent controls than in those without any controls.<sup>29</sup>

A 1984 in-depth analysis of the temperate rent controls in Los Angeles showed that controls were causing major transfers of resources from stayers to movers for reasons discussed above. In 1984, about 34 percent of the tenants in Los Angeles had not moved since rent controls were enacted in 1978; hence, their rents had increased only at the controlled rate. The study concluded that tenants' rents fell below both noncontrolled rents in surrounding communities and decontrolled rents in Los Angeles units that had recently become vacant by an average of \$47 and \$55 per month, respectively. In the absence of rent controls, these tenants would have been paying 1984 rents from 14 percent to 16 percent higher than their actual rents.<sup>30</sup>

In contrast, tenants who had resided in their 1984 units for only one to two years were paying rents from \$15 to \$28 per month higher than noncontrolled rents in nearby communities and recently vacated decontrolled rents, respectively. These movers were in effect subsidizing the stayers. Thus, the premiums these movers were paying on their rents greatly reduced the overall net loss that rent controls imposed upon owners. However, owners still suffered from some transfer of potential income to tenants because of rent controls.

<sup>24</sup>DeSalvo, *Reforming Rent Control in New York City*, pp. 22-42.

<sup>25</sup>Rydell and others, *Impact of Rent Control on the Los Angeles Housing Market*, p. vi.

<sup>26</sup>Ira S. Lowry, *The Financial Performance of Rental Property under Rent Control: Berkeley, California, 1978-1985* (California Housing Research Institute, CHRI 85-03, April 1985).

<sup>27</sup>Olson, *An Econometric Model of Rent Control*, pp. 1081-1100.

<sup>28</sup>Rydell and others, *Impact of Rent Control on the Los Angeles Housing Market*, pp. 127-134.

<sup>29</sup>Felix Ramon Barreto, *The Effects of Rent Control on Housing Production, Valuation and Tax Shifts* (New Brunswick: Rutgers University Ph.D. Thesis, May 1986), pp. 200-215.

<sup>30</sup>Hamilton and others, *Rental Housing Study*, Exhibit 2-12, following p. 32.

Thus the Los Angeles study found that owners of rent-controlled property in the city, on average, experienced somewhat lower increases in property values and net incomes than owners of similar noncontrolled rental properties in nearby communities. This was true even though owners of rent-controlled properties achieved respectable rates of return on their investments. The implication is that the temperate rent controls in Los Angeles did impose some relative capital losses on owners of rental property, compared to similar properties in nearby communities without controls.

The outcome of the Los Angeles study was probably greatly influenced by two key factors applicable in Los Angeles, but not necessarily in other areas. One is that total population and incomes within the Los Angeles area were rising notably during the study period. These population and income trends drove up the overall demand for land and therefore the market prices of most properties—even those locked in under rent controls—as the temperate control ordinance permitted buyers to shift properties to other uses. The second is that average tenant mobility in Los Angeles is particularly high. Few investors own properties occupied predominantly by stayers whose rents have remained well below market-clearing levels. If some other area that did not have these characteristics adopted a rent control ordinance similar to that of Los Angeles, the owners of rental properties in that area might not escape the negative impacts of such controls upon property values as much as Los Angeles owners did.

### **Conclusions**

Considering the above evidence, it appears that all rent controls, whether stringent or temperate, provide some net benefits to all tenants as a group by transferring some net resources from all owners as a group. Moreover, the total net amount of benefits received by the tenants is usually smaller than the total net amount of costs imposed upon the owners; hence, rent controls are not efficient at transferring resources from owners to tenants. Under some market circumstances—probably unusual ones—temperate rent controls with full or even partial vacancy decontrol may also transfer significant benefits to stayers at the expense of movers, thereby reducing the net losses suffered by rental property owners. If a particular market is also experiencing large increases in total rental housing demand and high rates of tenant turnover, the long-run losses in market value imposed upon owners by rent controls may be almost insignificant.

## **DISTORTIONS OF PROPERTY TAXES AND TAX BURDENS**

### **Theoretical Analysis**

Rent controls frequently cause the market values of controlled housing units to decline when compared to both their initial levels before controls and the levels of value attained by other types of real property that are not controlled. Such shifts change the way property tax burdens are allocated among different types of property owners within the community.

The current market values of controlled rental units are likely to fall for several reasons. First, the net operating incomes earned by owners often decline because controlled rents tend to rise more slowly than operating costs. Even if net operating incomes do not decline, mortgage lenders and equity investors who finance sales of such properties—and therefore establish their market prices—will consider such investments riskier than before controls were imposed. Lenders will advance loans covering a lower percentage of total value and may even charge higher interest rates than they did previously. Equity investors will also demand higher yields to offset increased risk, converting net income streams into values with higher capitalization rates—hence, lower market prices—than before controls. If local tax assessors accurately appraise controlled properties, they will assess them at lower values than before controls, thereby reducing the community's property tax base.

Even if the market values of controlled units do not fall absolutely, they will not rise with inflation as rapidly as the values of uncontrolled real estate in the same community—such as owner-occupied homes and commercial properties. Neither the incomes provided by commercial properties nor the prices of owner-occupied homes will be held down by controls. Therefore, as time passes, the market prices of rent-controlled units will almost certainly fall relative to the market prices of all uncontrolled real estate in the community. Assuming that tax assessors rapidly and accurately readjust assessed values to reflect actual market values, the total assessed value of rental housing will decline in absolute terms. Rental housing will therefore comprise a smaller percentage of total assessed values within the community than before controls existed.

As a result, homeowners and owners of commercial property will pay a larger relative share of the community's property tax burden just as owners of rent-controlled units will pay a smaller relative share. If the community maintains its previous absolute level of total receipts from property taxes by raising tax rates, rent controls will also increase the absolute tax burdens paid by owners of these other types of properties. Under such circumstances, rent controls impose a direct cost upon owners of uncontrolled property as well as upon owners of controlled housing units.

## Empirical Findings

One study of the impacts of rent controls in 88 New Jersey communities—half with controls and half without—indicated that the temperate controls caused assessed values of rental properties to rise less in controlled communities than in uncontrolled communities. However, the same study concluded that controls did not cause rental properties' total share of assessed values in rent-controlled communities to decline. Wherever such a decline had occurred, it was not significantly influenced by the presence of rent controls, but by other factors.<sup>31</sup> An earlier multiple regression study of other New Jersey communities reached the same conclusion.<sup>32</sup> The Rand Corporation analyzed likely future impacts of rent controls upon property tax revenues in Los Angeles and concluded that even the most stringent form of that city's relatively temperate controls would not have much impact upon property tax revenues.<sup>33</sup> Other studies of the effects of rent controls upon property tax burdens presented speculations about future impacts rather than actual evidence concerning effects that had already occurred.<sup>34</sup>

## Conclusions

Rent controls tend to reduce the assessed values of rental properties as compared to what they would have been in the absence of controls. However, there is no persuasive evidence that such controls reduce the share of total property taxes borne by rental housing so as to increase the shares borne by other types of properties.

## CREATION OF BURDENSOME ADMINISTRATIVE COSTS

### Theoretical Analysis

Rent controls cannot be effectively operated without complex bureaucratic systems to administer them. A special agency must be created and charged with administrative responsibility. Every existing rental housing unit within the area to be controlled must be registered with that agency. Under stringent ordinances, registration usually includes a detailed description of each unit's characteristics, its past and current rent levels, its current tenants and owners, and other facts. An agency administering a stringent ordinance must establish an appropriate controlled rent for every unit, and inform the owner and tenant of that rent. All rent control administrative agencies must set up machinery for processing all tenant complaints concerning excess rent charges and improper maintenance. Such agencies must also establish a process for determining the amounts by which owners who invest in property improvements can raise rents. And the

<sup>31</sup>Barreto, *Effects of Rent Control on Housing Production, Valuation and Tax Shifts*, pp. 216-225.

<sup>32</sup>John Gilderbloom, *Moderate Rent Control: The Experiences of U.S. Cities* (Washington, D.C.: Conference on Alternative State and Local Policies, May 1980). The conference is a clearinghouse located at 2000 Florida Avenue, N.W., Washington, D.C. 20009. (Telephone 202-387-6030.)

<sup>33</sup>Rydell and others, *Impact of Rent Control on the Los Angeles Housing Market*, pp. 69-76.

<sup>34</sup>For example, Sternlieb, Lett, and others, *Rent Control in Fort Lee, New Jersey*. Sternlieb's predictions about future changes in assessed values were later criticized as erroneous by Gilderbloom, *Moderate Rent Control: The Experiences of U.S. Cities*.

agencies must set up at least an annual review of how much rents in general will be allowed to rise each year.

In large jurisdictions containing thousands, hundreds of thousands, or even millions of rental units, performing these administrative tasks requires a great deal of time, effort, personnel, and money. In addition, both owners and tenants incur large costs in time, money, and effort in coping with a rent control system. They must fill out forms, spend time communicating with and visiting rent control offices, and—if they wish to appeal—devote time and incur expenses in testifying or defending themselves. The total losses of time, money, and effort involved are far from trivial.

### **Empirical Findings**

The total public sector costs of administering rent control systems vary substantially, depending on type of ordinance involved. In Los Angeles, which has a temperate ordinance, the annual budget for administering rent control covering 487,700 units is \$6.2 million, or about \$13 per unit. The annual fee each owner must pay equals \$7 per unit. In adjacent Santa Monica, which has a stringent ordinance, the annual budget for administering about 30,000 units is \$4.2 million, or \$140 per unit. The annual fee each owner must pay equals \$144 per unit. In fact, administrative costs of rent control equal around 2 percent of all tenants' total rent bill in Santa Monica, but only 0.2 percent in Los Angeles.