DETRIMENTAL EFFECTS OF RENT CONTROL

Currently there is a drive by many local communities from the East to the West Coast to enact rent control as a method to assist low income households and the elderly to cope with shrinking real income. As of mid-1976 over two hundred communities, mostly concentrated on the East Coast, had some form of rent control. These rent controlled communities housed about 14 percent of the United States urban population. However, the potential number is much greater since about 28 percent of all urban dwellers live in areas with state enabling laws or in areas where state and local governments have recently considered rent control legislation. Considering the potential number of localities that could enact rent controls it is in the best interest of the real estate community to understand the implications of rent control and inform localities of the likely consequences of their action.

Maintenance and Repair Reduced

When rent controls are imposed that do not provide for adequate pass-through of taxes and expenses the initial consequence is a reduction in net income to owners. On balance, advocates of rent control might not view this as harmful; however, owners will be discouraged from making routine maintenance and repairs because of the lower return. Rental housing, like alternative investments, must offer a rate of return that is competitive with investments of comparable risk. Consequently, as costs rise and rent collections remain stable, or increase at a rate below costs, return to the investor is diluted. Under these conditions investors are faced with a choice of accepting a rate of return not commensurate with risk, or attempting to reduce costs in order to equalize the return. Often the easiest and most immediate way to reduce cost is to limit expenditures for maintenance and repairs. However, as outlays for maintenance and repairs are reduced tenants become dissatisfied and friction between owners and tenants erupt.

Data from five large cities—two with rent controls, three without—illustrate the lower level of maintenance in rent control areas (Table A). From 1968 to 1977 the percent of gross income going for maintenance and repair in elevator buildings show New York City and Boston (two rent controlled areas) with the lowest rates. Owners of elevator buildings in New York and Boston spent an average of 6.5 percent and 7.2 percent, respectively, of their gross income on maintenance, repairs and decorating. In the non-controlled areas of Baltimore, Chicago and San Francisco owners spent relatively larger sums on these items.

TABLE A
EXPENDITURES FOR MAINTENANCE AND REPAIRS IN UNFURNISHED ELEVATOR BUILDINGS, BY SELECTED CITIES
1968-1977
(Percent of Gross Income)

Year	New York	Boston*	Baltimore	Chicago	San Francisco
1968	7.3%	10.7%	8.0%	8.2%	8.2%
1969	7.9	10.3	7.4	7.1	8.1
1970	7.0	8.0	8.0	7.9	8.2
1971	5.4	8.7	8.6	8.0	10.2
1972	4.0	6.0	8.0	6.8	9.5
1973	5.8	5.9	7.0	7.5	8.0
1974	6.3	5.9	7.8	7.9	9.1
1975	6.9	7.6	9.1	8.4	11.0
1976	6.7	6.5	8.3	7.7	10.8
1977	7.9	9.0	9.1	7.2	10.4
Average	6.5%	7.2%	8.1%	7.7%	9.4%

*Boston's average calculation is based on data from 1970-1977, since rent control was introduced in that area in 1970.

Source: Income/Expense Analysis, Apartments, Condominiums and Cooperatives, Institute of Real Estate Management, Chicago, Illinois.

Property Value Diminished

With reduced income potential and increased risk associated with rent control, the real value of controlled units declines. A good indication of the desirability of a rental property is the ratio of the property value to the rent roll. As the potential profitability, as viewed by the investor, is reduced the property's value falls and the ratio declines. Prior to the enactment of strict rent controls in New York a typical rental complex sold for five to seven times the annual rent rolls. Currently the ratio is two to three times rent rolls, and in some cases the price is equal to one year's rent. In 1974 alone, it was estimated that the market value of rent controlled property in New York City declined by 31 percent and that property subject to rent stabilization declined by 18 percent. New York is not alone in this phenomenon. Three years after the city of Cambridge, Massachusetts adopted rent controls the city experienced its first decline in its tax base since the great depression. This decine occurred despite the fact that single-family home construction continued and several large industrial and commercial establishments were built thus adding to the tax base. Even though new construction has contributed to Cambridge's tax base and inflation has pushed up the value of properties the total assessed valuation of real property in Cambridge was lower in 1976 than in 1970, the year controls were instituted.

Tax Base Declines

Under rent control a declining real tax base from multifamily rental units is a virtually inescapable conclusion. The value of income producing properties to an investor is directly related to the income producing potential of that property. If the net income from a property decreases the ability of the property to bear tax is diminished. Consequently, tax revenues from that sector are reduced. Thus, in order for a municipality to generate a steady or an increasing amount of revenues from property taxes, other sectors must bear a heavier tax burden, most notably, the single-family sector. The effects of a tax shift are covered in more detail in a companion briefing paper.

Delinquencies Increase

Tax delinquencies tend to be considerably higher in rent controlled areas. In New York City, for example, real estate tax delinquencies in 1975 were at an annual rate of six percent, the highest in 40 years. It was estimated that in 1976 over one fifth of all walk-up buildings in New York—virtually all rent controlled—were delinquent in tax payments. After the introduction of rent controls in Boston the tax delinquency rate almost doubled. On the other hand, the non-rent controlled city of Baltimore had a substantially lower delinquency rate of only 2.2 percent in fiscal year 1977.

A sound tax base is essential for the fiscal health of most communities. In the rent controlled cities of New York City and Boston about 25 percent of the rent is earmarked for local property tax. Consequently, areas with rent control are giving up, for all practical purposes, 25 percent of the potential property tax receipts between the actual controlled rent and the fair market rent. For example, if the controlled rent is $200 and if the open market rent would be $300, the local taxing authority would forfeit 25 percent × 100 × 12 months = $300 per year per controlled unit. This figure multiplied by the number of controlled units would contribute a significant amount of tax dollars to any local coffer. Moreover, if the monies are needed to continue to finance local services, the lost revenues must be made up through greater real estate tax receipts from single-family homes and/or commercial and industrial property. Most often, political realities prevent tax authorities from raising the tax rate to fully compensate for lost revenues from rental housing, and consequently, local vital services are curtailed and the credit worthiness of the local government could be undermined.

Financing Difficult to Find

Even at the depressed market value of rental properties in rent controlled areas, lenders are reluctant to finance properties because of the increased risk. Even when lenders are willing to extend refinancing in rent controlled communities the interest rate premium asked can mean the difference between the success or failure of a rental property. In addition to higher interest to compensate for increased risk, lenders often require potential owners to put up 40 percent or more equity instead of the traditional lower percentage. Owners usually do not have the necessary cash for the added equity nor the ability to pay the higher finance charges because of limited cash flow. On balance, financing is the life blood of the real estate industry. In the absence of adequate financing, properties become less liquid and that in itself could cause a sharp decline in value.

The Center for Urban Policy Research at Rutgers University surveyed 31 lending institutions in the Boston area concerning the effects of rent controls on their decision to lend money. Of these respondents, two institutions said rent controls did not influence their decision while 25 said that rent controls have made them more conservative in their lending practices. Washington, D.C.'s leading mortgage lender has publicly stated that no loans will be considered for apartment developers until there is an adequate return to the investor. Attitudes expressed by lending institutions suggest that it may be impossible to increase the residential rental housing stock in rent controlled areas since the financing of such projects will be difficult at best.

Construction Declines, Condominium Conversions Rise

Increased risks associated with operating apartment units in rent controlled areas has the effect of reducing the rental housing stock through increased condominium conversions and reduced levels of new construction. Lower rates of return encourage apartment owners to convert their buildings to for sale units or to apartment hotels since returns on these types of properties are not artificially constricted. In addition, new construction is slowed

even if new units are exempt from controls. First, how believable is the exemption for new units? Subsequent rent control legislation could subject new units to the same income constraints as existing properties. Second, developers will not construct new units in controlled areas because they would have a difficult time in competing with the controlled housing stock. For new units in a controlled area the owner will seek rents which are usually significantly above controlled units, reflecting higher construction costs. Consequently, the non-controlled new units must compete with the existing inventory and price competition under these conditions is virtually impossible until all of the existing units are absorbed. Higher vacancy rates are more prevalent in non-controlled units relative to controlled units in rent control areas.

On balance, everyone is hurt by rent controls and the efficiency of the total housing stock is reduced. Although tenants with limited incomes might pay less rent in absolute terms, the quality of their units is likely to display some deterioration given reduced owner outlays for maintenance and repairs. Also, younger households looking for an apartment could experience difficulty in obtaining one given the reduced supply. The incentive for tenants of controlled properties to stay-put is great which reduces the efficiency of the total housing stock. Older tenants continue to occupy accommodations larger than the physical size their households would require, simply to continue to enjoy the artifically low rent. Rent control under these conditions is little more than a subsidy for middle/upper income households and is not really helping households the controls were intended to assist. Renters of controlled units, to a large extent, may be in a higher income bracket relative to the owner.

Administrative Costs Rise

Aside from the disruptive market effects created by rent controls another bureaucracy is established. Administering rent control mechanisms can be quite expensive, but costs vary widely depending upon the rent control formula used in the particular community. In 1976, New York City appropriated over $13 million for their rent control program, which is in excess of $20 per controlled unit. Boston's programs cost $8.42 per unit in fiscal year 1977, while Washington, D.C. had a unit cost of $4.28. However, it was estimated by the Washington, D.C. Rental Accommodations Commission that to administer the program more efficiently the cost per unit would be around $17.00. Although these costs are somewhat covered by apartment registration fees the lion's share must still be borne by the general public.