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Bankrupt Landlords, from Sea to Shining Sea

Take a tour of Santa Monica, a beachfront enclave of Los Angeles, and you will find a city of bizarre contrasts. Pick a street at random, and you will likely find run-down rental units sitting in disrepair next to homes costing $500,000. Try another street, and you will find abandoned apartment buildings adjacent to luxury-car dealerships and trendy shops that sell high-fashion clothing to Hollywood stars. Sound strange? Not in Santa Monica—known locally as the People's Republic of Santa Monica—where stringent rent-control laws once routinely forced property owners to leave their buildings empty and decaying rather than even bothering to sell them.

Three thousand miles to the east, rent-control laws in New York City—known locally as the Big Apple—have forced landlords to abandon housing units because the owners no longer could afford the resulting financial losses. Largely as a result of such abandonments, the city government of New York owns thousands of derelict housing units—empty, except for rats and small-time cocaine dealers. Meanwhile, because the controls also discourage new construction, the city faces a housing gap of 200,000 rental units—apartments that easily could be filled at current controlled rental rates, if the units existed in habitable form.

From coast to coast, stories like these are commonplace in the 200 or so American cities and towns that practice some form of **rent control**—a system in which the local government tells building owners how much they can charge for rent. Time and again, the stories are the same: poorly maintained rental units, abandoned apartment

buildings, tenants trapped by housing gridlock in apartments no longer suitable for them, bureaucracies bloated with rent-control enforcers, and even homeless families that can find no one who will rent to them. Time and again, the reason for the stories is the same: legal limits on the rent that people may pay for a place to live.

Our story begins in 1943, when the federal government imposed rent control as a temporary wartime measure. Although the federal program ended after the war, New York City continued the controls on its own. Under New York's controls, a landlord generally could not raise rents on apartments as long as the tenants continued to renew their leases. Rent controls in Santa Monica are more recent. They were spurred by the inflation of the 1970s, which, combined with California's rapid population growth, pushed housing prices and rents to record levels. In 1979, the city of Santa Monica (where 80 percent of the residents were renters) ordered rents rolled back to the levels of the year before and stipulated that future rents could go up by only two-thirds as much as any increase in the overall price level. In both New York and Santa Monica, the objective of rent controls has been to keep rents below the levels that would be observed in freely competitive markets. Achieving this goal required that both cities impose extensive regulations to prevent landlord and tenant from evading the controls—regulations that are costly to enforce and that distort the normal operation of the market.

It is worth noting that the rent-control systems in New York and Santa Monica are slowly yielding to decontrol. For a number of years, some apartments in New York have been subject only to "rent stabilization" regulations, which are somewhat less stringent than absolute rent controls. In addition, New York apartments going for over $2000 per month are deregulated when a lease ends. In Santa Monica, the state of California mandated that, effective in 1999, rent for newly vacant apartments could increase. Even so, in both cities, much of the rental market is dominated by rent controls. Accordingly, in this chapter we focus on the consequences of those controls.

In general, the unfettered movement of rental prices in a freely competitive housing market performs three vital functions: (1) it allocates existing scarce housing among competing claimants; (2) it promotes the efficient maintenance of existing housing and stimulates the production of new housing, where appropriate; and (3) it rations usage of housing by demanders, thereby preventing waste of

scarce housing. Rent control prevents rental prices from effectively performing these functions. Let's see how.

Rent control discourages the construction of new rental units. Developers and mortgage lenders are reluctant to get involved in building new rental properties because controls artificially depress the most important long-run determinant of profitability—rents. Thus, in one recent year, 11,000 new housing units were built in Dallas, a city with a 16 percent rental vacancy rate but no rent-control statute. In that same year, only 2000 units were built in San Francisco, a city with a 1.6 percent vacancy rate but stringent rent-control laws. In New York City, the only rental units being built are either exempt from controls or are heavily subsidized by the government. Private construction of new apartments in Santa Monica also dried up under controls, even though new office space and commercial developments—both exempt from rent control—were built at a record pace.

Rent control leads to the deterioration of the existing supply of rental housing. When rental prices are held below free market levels, property owners cannot recover through higher rents the costs of maintenance, repairs, and capital improvements. Thus such activities are sharply curtailed. Eventually, taxes, utilities, and the expenses of the most rudimentary repairs—such as replacing broken windows—overwhelm the depressed rental receipts; as a result, the buildings are abandoned. In New York, some owners have resorted to arson, hoping to collect the insurance on their empty rent-controlled buildings before the city claims them for back taxes. Under rent controls in Santa Monica, the city insisted that owners wishing to convert empty apartment buildings into other uses had to build new rental units to replace the units they no longer rented. At a cost of up to $50,000 per apartment, it is little wonder that few owners were willing to bear the burden, choosing instead to leave the buildings empty and graffiti-scarred.

Rent control impedes the process of rationing scarce housing. One consequence of this is that tenant mobility is sharply restricted. Even when a family's demand for living space changes—due, for example, to a new baby or a teenager's departure for college—there can be substantial costs in giving up a rent-controlled unit. In New York City, landlords often charge "key money" (a large, up-front cash payment) before a new tenant is allowed to move in. The high cost of moving means that large families often stay in cramped

quarters whereas small families, or even single persons, reside in very large units. In New York, this phenomenon of nonmobility came to be known as *housing gridlock*. In Santa Monica, many homeowners rented out portions of their houses in response to soaring prices in the 1970s and then found themselves trapped by their tenants, whom they could not evict even if they wanted to sell their homes and move to a retirement community.

Not surprisingly, the distortions produced by rent control lead to efforts by both landlords and tenants to evade the rules. This in turn leads to the growth of cumbersome and expensive government bureaucracies whose job is to enforce the controls. In New York, where rents can be raised when tenancy changes hands, landlords have an incentive to make life unpleasant for tenants or to evict them on the slightest pretense. The city has responded by making evictions extremely costly for landlords. Even if a tenant blatantly and repeatedly violates the terms of a lease, the tenant cannot be evicted if the violations are corrected within a "reasonable" time period. If the violations are not corrected—despite several trips to court by the owners and their attorneys—eviction requires a tedious and expensive judicial proceeding. For their part, tenants routinely try to sublet all or part of their rent-controlled apartments at prices substantially above the rent they pay the owner. Because both the city and the landlords try to prohibit subletting, the parties often end up in the city's Housing Courts, an entire judicial system developed chiefly to deal with disputes over rent-controlled apartments.

Strict controls on monthly rents force landlords to use other means to discriminate among prospective tenants. Simply to ensure that the rent check comes every month, many landlords rent only to well-heeled professionals. As one commentator put it, "There is no disputing that Santa Monica became younger, whiter, and richer under rent control." The same pattern occurred under the rent-control laws of both Berkeley, California, and Cambridge, Massachusetts.

There is little doubt the bureaucracies that evolve to administer rent-control laws are cumbersome and expensive. Between 1988 and 1993 New York City spent $5.1 billion rehabilitating housing confiscated from private landlords. Even so, derelict buildings continued piling up at a record rate. The overflow and appeals from the city's Housing Courts clog the rest of New York's judicial system, impeding the prosecution of violent criminals and drug dealers. In Santa Monica, the Rent Control Board began with an

annual budget of $745,000 and a staff of 20 people. By the early 1990s, the staff had tripled in size and the budget was pushing $5 million. Who picked up the tab? The landlords did, of course, with an annual special assessment of $200 per unit levied on them. And even though the 1999 state-mandated changes in the law meant that apartment rents in Santa Monica can be increased when a new tenant moves in, the new rent is then controlled by the city for the duration of the tenancy. Indeed, the Rent Control Board conveniently maintains a Web site where one can go to learn the Maximum Allowable Rent on any of the tens of thousands of rent-controlled residences throughout Santa Monica.

Ironically, the big losers from rent control—in addition to landlords—are often low-income individuals, especially single mothers. Indeed, many observers believe that one significant cause of homelessness in cities such as New York and Los Angeles is rent control. Often, poor individuals cannot assure the discriminating landlord that their rent will be paid on time—or paid at all—each month. Because controlled rents generally are well below free-market levels, there is little incentive for apartment owners to take a chance on low-income individuals as tenants. This is especially true if the prospective tenant's chief source of income is a welfare check. Indeed, a significant number of the tenants appearing in New York's Housing Courts have been low-income mothers who, due to emergency expenses or delayed welfare checks, have missed rent payments. Often their appeals end in evictions and new homes in temporary public shelters or on the streets. Prior to the state-mandated easing of controls, some apartment owners in Santa Monica who used to rent one- and two-room units to welfare recipients and other low-income individuals simply abandoned their buildings, leaving them vacant rather than trying to collect artificially depressed rents that failed to cover operating costs. The disgusted owner of one empty and decaying eighteen-unit building had a friend spray-paint his feelings on the wall: "I want to tear this mess down, but Big Brother won't let me." Perhaps because the owner had escaped from a concentration camp in search of freedom in the United States, the friend added a personalized touch: a drawing of a large hammer and sickle, symbol of the former Soviet Union.

It is worth noting that the ravages of rent controls are not confined to capitalist nations. In a heavily publicized news conference

several years ago, the foreign minister of Vietnam, Nguyen Co Thach, declared that a "romantic conception of socialism" had destroyed his country's economy after the Vietnam War. Mr. Thach stated that rent control had artificially encouraged demand and discouraged supply, and that all of the housing in Hanoi had fallen into disrepair as a result. Thach concluded by noting, "The Americans couldn't destroy Hanoi, but we have destroyed our city by very low rents. We realized it was stupid and that we must change policy."

Apparently, this same thinking was what induced the state of California to compel changes in Santa Monica's rent-control ordinance. The result of that policy change was an almost immediate jump in rents on newly vacant apartments, as well as a noticeable rise in the vacancy rate—both results being exactly what we would expect. Interestingly enough, however, prospective new tenants were less enthusiastic about the higher rents than many landlords had expected. The reason? Well, 20 years of rent controls had produced that many years of reduced upkeep, and thus apartments that were, well, less than pristine. As one renter noted, "The trouble is, most of this area . . . [is] basically falling apart." And another complained, "I don't want to move into a place that's depressing, with old brown carpet that smells like chicken soup." Higher rents are gradually changing both the ambiance and the aroma of Santa Monica apartments—but only at the same rate that the market is allowed to perform its functions.

DISCUSSION QUESTIONS

1. Why do you think governments frequently attempt to control apartment rents but not house prices?
2. What determines the size of the key-money payments that landlords demand (and tenants offer) for the right to rent a controlled apartment?
3. Who, other than the owners of rental units, loses as a result of rent controls? Who gains from rent controls? What effect would the imposition of rent controls have on the market price of an existing single-family house? What effect would rent controls have on the value of vacant land?