Research Department
Federal Reserve
Bank of
San Francisco

June 13, 1980

FRBSF Weekly Letter

Tenants' Complaints

"Nobody shoulders a rifle in defense of a boarding house."—Bret Harte

Bret Harte's quip about the political vulnerability of landlords has taken on a new meaning in recent years—witness California's rejection last week of a landlord-sponsored initiative to curb local rent-control ordinances. Indeed, decisions about rental housing are increasingly made in the voting booth or City Council chambers rather than in the marketplace. Rent control, once a phenomenon of New York City alone, has now spread to other parts of the country, including such West Coast communities as Los Angeles, Berkeley, San Francisco and Seattle. Some local communities also have instituted ordinances to restrict the conversion of rental property to condominiums.

These measures reflect a widespread desire to address a perceived national crisis: rising rental costs and a diminished supply of rental housing. Behind the good intentions, however, are some serious misunderstandings about the way housing markets work. Existing controls might actually increase the cost and reduce the effective supply of housing—presumably the opposite of their intended effects. Moreover, they could divert attention from truly effective housing policies.

The market

The key point to remember is that rental housing "competes" with the other form of housing tenure—owner-occupancy. In choosing between the two, a household compares the market rent of housing of a particular type with the costs that it would expect to incur over a given period of time as owner-occupants of similar housing. These homeownership costs include the foregone earnings on equity in the house, plus maintenance costs and mortgage costs, net of any expected capital gains—all on an *after-tax* basis.

Lifestyles and economic circumstances will dictate that some households become homeowners and that others become renters. Indeed, for some families, homeownership is simply not feasible. This does not mean, however, that there is no effective competition between renting and owning. There are always families on the margin of this choice, and a severe imbalance between rental and homeownership costs at this margin cannot persist; if such an imbalance develops, the actions of these "marginal" households will tend to bring costs back into line. If, for example, some event causes homeownership to be perceived as cheaper than renting, the marginal households will become owner-occupants, thereby reducing the demand for rental housing and causing rents to fall relative to the costs of owner-occupancy. The market will then reach a new equilibrium at a lower proportion of renters (and rental housing) than before.

The market in the 1970's

Apparently this is what occurred during the 1970's. As the decade progressed and inflation unexpectedly worsened, many households correctly perceived that owner-occupancy was a cheaper alternative than renting; when expected capital gains (and their special tax treatment) were taken into account, the purchase of a home made economic sense, even at high prevailing mortgage rates. Of course, this new enthusiasm for owner-occupied housing caused housing prices to be bid up, and therefore was partly self-defeating. However, builders responded with new supply, and even with gigantic price rises, home ownership for many households still seemed relatively inexpensive.

Consequently, rents were *bid down relative to other prices*, as rental housing tried to compete with the inflation and tax advantages of homeownership, and as the proportion of rental households shrank with the growing

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switch to owner-occupancy. The data clearly show that this chain of events actually occurred. Rents *fell* relative to other prices over the decade by approximately 8 percent (see chart). And the proportion of households renting shrank from 37 to 35 percent, nearly double the percentage decrease of the previous decade.

The condominium-conversion phenomenon of the 70's also reflected this process. Because of the tax treatment of *rental* property, according to a recent Commerce Department study, inflation does *not* make it cheaper for the landlord to own housing. Therefore, downward pressure on real rental income has *not* been offset by lower landlord costs, in real terms. In the final analysis, the conversion of rental property to condominiums occurred *because it became cheaper for households to own (and live in) apartments than it was for landlords to own the units and rent them out* (after adjustment for the effects of taxes and inflation expectations). To put it bluntly, each converted unit was worth more to the household than it was to the landlord, reflecting the fact that the landlord had a strong incentive to sell rather than rent.

Seeds of discontent

The forces creating these changes are beyond landlords' control. The shift out of rental housing has occurred because of the *desires of households*, propelled by the effects of inflation and homeowners' special tax treatment. Indeed, in real terms, rents have actually fallen—virtually continuously—for over a decade. This situation doesn't seem to jibe with the image of landlords as merciless "gougers" of their unfortunate tenants.

Several factors may have contributed to this misconception of landlord behavior. First, despite the decline in real rents (i.e., rents relative to other prices), nominal rents have indeed risen. It is natural for all of us to blame sellers of goods and services rather than government policy for rising prices. Landlords may have been singled out simply because they are highly visible and politically vulnerable sellers.

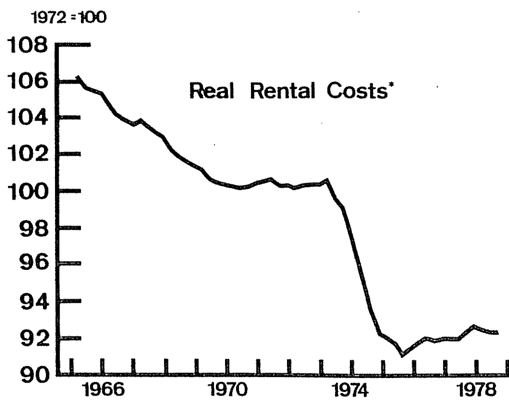
Second, the composition of rental households has changed because of the working-out of inflationary processes. Only those with relatively high tax rates (and hence, high incomes) have sufficient incentive to move from rented housing to owner-occupancy as inflation expectations rise. As a result, rental housing becomes increasingly occupied by poorer households. (Renters earned 64 percent of the national median income in 1970, but only 55 percent in 1977.) The burden of today's rents may seem very high to such a group, despite the relative decline in real rents nationwide.

Finally, in some localities real rents may have actually risen, because of local-government restrictions on housing supply coupled, perhaps, with heavy in-migration. (However, real rents have *not* risen in San Francisco, Los Angeles and certain other areas where renter discontent appears to be very high.) And clearly, landlords could hardly be blamed for rising rents where such factors were in evidence.

Attempts at control

Whatever the genesis of renter discontent, the simple fact remains that tenants outnumber landlords—so that rent control perennially remains an attractive legislative issue. The typical rent-control ordinance permits rents to rise only by the costs of maintenance and other variable costs, and forces landlords to document these costs in hearings before special boards.

Proponents of rent control see such regulation as a "fair" means of rewarding the landlord with "justified" increases while protecting the tenant from being "gouged." But this argument incorporates some rather questionable economics. The market rent, to repeat, is determined in competition with the owner-occupied alternative; if rents are "too high" relative to the true costs of owning housing, tenants will switch to ownership status until rents are brought into line. In con-



*Rental component of the CPI deflated by the personal consumption expenditures price index.

trast, if rents are held *below* their equilibrium value (below cost) through rent controls, capital will simply flow out of rental housing until costs and rents are once again in line.

This process of disinvestment generally occurs slowly (through under-maintenance and slowed construction) but it can, in extreme cases, occur quickly through condominium conversions, abandonment or demolition. However it occurs, the available supply of rental housing will decline, in quantity or in quality. (As far as the tenant is concerned, a decrease in the quality of housing at a fixed rent is the same as an increase in rents in well-maintained housing.) Thus the very goals of the policy—controlling costs and supply—appear doomed to fail.

Attempts to preserve the supply of rental housing by banning condominium conversions similarly seem doomed to failure. By definition, a landlord is induced to sell rental units as condominiums when the capital in the rental housing is more valuable in an alternative use (owner-occupied housing) than it is in the rental market. If capital is not permitted to flow out of rental housing in this manner, it will flow out through undermaintenance—usually with serious consequences for the neighborhood as a whole.

For these reasons, rent controls must be deemed a failure world-wide. Most of Western Europe—France, West Germany, Holland—is now dismantling the wartime legacy of rent controls. Europe's experience with rent controls has been devastating: there is virtually no private construction of rental housing except at the luxury level, and government housing agencies have been unable to provide substitute public housing. Poor maintenance of rent-controlled housing has created many substandard dwellings, despite laws designed to punish landlords who fail to maintain their property. France in 1971 set up a special agency—the National Agency for Improvement of Housing—to deal with the increasing deterioration of the rental housing stock.

The United States has encountered similar problems with rent controls. In New York City, where controls have been in force since World War II, the result has been a virtually continuous decline in both the absolute numbers of rental units and their share in the total housing stock. Approximately 10 percent of the housing units standing in New York in 1970 have been lost since then to deterioration and abandonment. Most of the units were rental units. New construction, while partially offsetting the overall loss of housing, primarily has represented owner-occupant housing.

The solution

Ultimately, we can provide economical housing only by encouraging additions to supply—that is, encouraging new construction. Only then will there be sufficient alternatives for households so that active competition will restrain housing costs and market rents. New construction need not be tailored to the rental market to provide benefits for the renter population; competition at the margin between renting and owning ensures that rents and homeownership costs will move together.

Curiously, many communities which impose rent controls also attempt to restrain new development—Berkeley is one such community—usually with the aim of "preserving" the character of existing neighborhoods. This combination of policies practically guarantees that neither will be successful. The undermaintenance that occurs in such situations gradually raises implicit rents by lowering the quality of housing services and, at the same time, destroys the quality of the neighborhood itself.

Randall Pozdena

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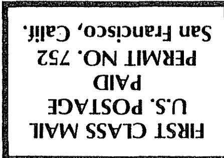

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/28/80	Change from 5/21/80	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	136,599	– 146	9,942	7.8
Loans (gross, adjusted) — total#	115,092	– 13	11,441	11.0
Commercial and industrial	33,048	209	2,232	7.2
Real estate	46,356	34	8,738	23.2
Loans to individuals	23,873	– 29	1,835	8.3
Securities loans	1,032	– 103	– 576	– 35.8
U.S. Treasury securities*	6,207	– 145	– 1,521	– 19.7
Other securities*	15,300	12	22	0.1
Demand deposits — total#	41,954	788	– 381	– 0.9
Demand deposits — adjusted	29,311	– 392	– 556	– 1.9
Savings deposits — total	26,594	196	– 3,250	– 10.9
Time deposits — total#	64,539	354	14,362	28.6
Individuals, part. & corp.	55,099	– 235	14,283	35.0
(Large negotiable CD's)	22,822	– 31	5,973	35.5

Weekly Averages of Daily Figures	Week ended 5/28/80	Week ended 5/21/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	336	199	13
Borrowings	44	2	202
Net free reserves (+)/Net borrowed(–)	292	197	– 189

* Excludes trading account securities.
# Includes items not shown separately.

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