

Zisler Capital Associates, LLC

Outsourced
Research and Capital

Rent Control *Redux*: Still a Bad Policy¹

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“The best laid schemes of mice and men
Go often askew,
And leave us nothing but grief and pain,
For promised joy!”

To a Mouse

On Turning up in Her Nest with the Plough, November, 1785

By Robert Burns

¹ I believe that a just society should embrace a strong safety net and that government, in principle, can, and should, play an important role, especially where private markets fail. However, I do not believe that rent control as redistribution, especially if imposed at the local level, is an appropriate means to achieve that end. Mobility at the local level is higher than at the national level and people tend to vote with their feet. This article explains why.

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Rent Control *Redux*: Still a Bad Policy

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The rise of inequality, the silent crisis of affordability and rental insecurity, decades of stagnant real wages for much of the working middle class have reignited calls for rent control, especially in those cities with rapid property appreciation and rental growth. Renter groups clamor for protection and politicians in many, but not all, cities are eager to accommodate this cry for relief. This article reports that rent control in its many forms is an unalloyed bad; its effects are pernicious and those intended beneficiaries—not the lucky ones who find a controlled unit but the renter class as a whole—suffer the most. Rent control is a blunt instrument; its benefits are capricious. Rather than rent control, the solutions should include more, not less, construction as well as income support for the less fortunate.



Apartments are now a significant institutional investment class. However, such was not the case in the 1980s when the specter of rent control, far overblown at the time, delayed institutional entry into this property class. With

an abundance of capital and no research, fearless institutions eventually embraced apartments. Nobody cared about rent control, but now rent control is a big issue in some cities.

What are the deleterious effects of rent control and are these effects sufficient to undermine institution's commitment to apartments? Whom does rent control help? Who suffers? Who benefits? Does the market blunt and even defeat the intended purpose of rent control over time? If there are market distortions, are these distortions significant? If local governments want to redistribute income without causing its high income residents to opt out and vote with their feet, is rent control the best tool, or even the second best tool? Are there new lessons to be learned or should we just dust off the old, often forgotten lessons?

Types of rent control. Rent control covers very few markets although more cities, especially those with more rapid rental growth, have adapted rent control measures. Rent control comes in many forms, some less harmful than others. The basic types of rent control either (1) set a ceiling or (2) limit the change in rents. New York City's rent control immediately following WW II, a true rent ceiling, is an example of first generation rent control. The latter is rent stabilization, or second generation rent control. A common form of rent control allows for tenant-landlord negotiation but imposes a limit on the amount of the rent

increase. For example, California state legislators just passed a law that limits annual rent increases to five percent plus the rate of inflation and places certain restrictions on evictions. Earlier this year, Oregon adopted the nation's first statewide mandatory rent control measure that limits rent increases once per year to no more than seven percent plus inflation. In some cases, the maximum percentage increase is so high that in all but the most unusual circumstances rent control is not binding, or if it is, its deleterious effects are limited. Additional provisions regulate when a landlord can evict a

tenant. What happens when the tenant of a rent controlled apartment vacates. Is it decontrolled?

Rent control as a price ceiling. Economists are practically unanimous regarding first generation rent ceilings: Long term rent ceilings reduce the quantity and quality of controlled rental units. Since rents are not allowed to clear the market, landlords will allow a unit to deteriorate to the point that the landlord's return on equity and the quality-adjusted rent approaches market equilibrium.

Exhibit 1. Economics of rent control

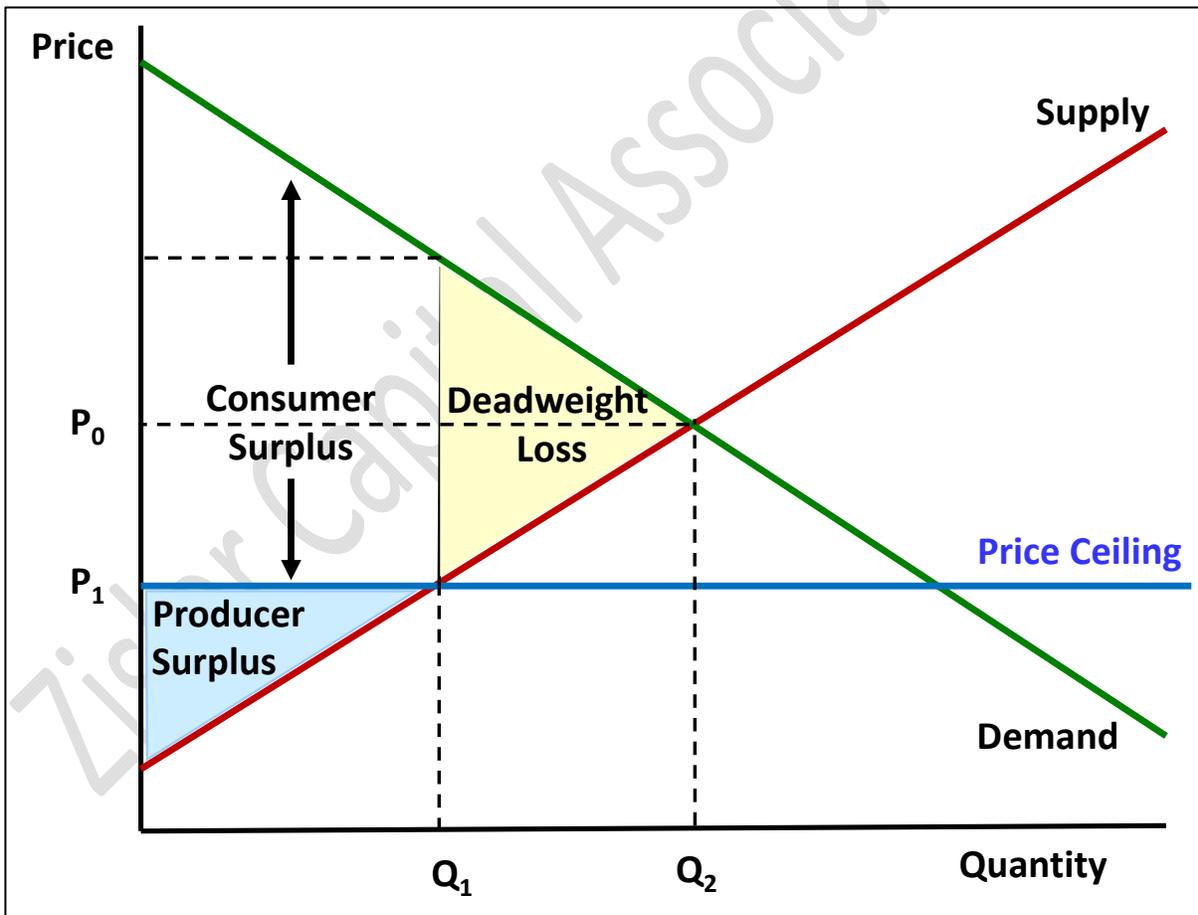


Exhibit 1 shows the apartment demand and supply curves for a local municipality. The equilibrium price is P_0 . Imposition of a ceiling sets the price at P_1 . The ceiling creates excess demand, $Q_2 - Q_1$. The market wants to supply only Q_1 . Since housing is durable, the owner, in order to maintain the required return on equity, allows the property to deteriorate. The quality adjusted supply declines.

In the short-run, consumer surplus increases and producer surplus decreases. However, there is a deadweight loss, which is a loss to society. The increase in consumer surplus is a transfer from producers.

Rent ceilings create excess demand and the highest-benefit users, the so-called beneficiaries of rent control, may not be the ones who secure a rent-controlled unit. Housing access becomes a lottery, and often the well connected, the better educated, and even the wealthier tenants win. The price system does not direct resources to those who are willing to pay the most.

Rent control through its implicit subsidy discourages tenant mobility and increases tenant commutation and tenant search costs. Reduced mobility is inefficient. Tenants settle for second best employment opportunities that are less apt to endanger the valuable rent controlled tenancy. Rent control distorts labor market decisions

Rent control increases tenant search costs. Locating a rent controlled unit is itself an exercise in asymmetric information and an unwarranted imposition on the less well informed. Knowing a relative or a friend who rents a controlled unit can confer generational value. By contrast, a market without rent controls continually provides a variety of rental choices in many locations and at various quality

levels. A properly functioning market provides greater choice.

Landlords, constrained in their ability to set a market-clearing rent, use non-price rationing which can include discrimination, quality deterioration, substitution of rental for landlord maintenance, bribes, and spillover into the uncontrolled sector.

Rent control tends to transfer units from the rental sector to the ownership sector, thus reducing the inventory of apartments. Suppliers of new rental apartments may exit the market and shift their business focus to the construction of condominiums and single family housing.

A Stanford study shows that rent control increased renters' probabilities of staying at their addresses by nearly 20%. Rental housing supply in the controlled sector decreased by 15%, causing a 5.1% city-wide rent increase. Rent control offered large benefits to covered tenants. The authors suggest that welfare losses from decreased housing supply could be mitigated if insurance against rent increases were provided as government social insurance, instead of a regulated landlord mandate.

Fiscal implications. Rent control inhibits new apartment construction and reduces the value of controlled units, which in turn reduces property tax revenues and impairs the provision of governmental services. A partially offsetting factor is the impact of rent controlled on the uncontrolled sector. The uncontrolled sector satisfies some, but not all, of the excess demand; uncontrolled rents rise to market levels. Rent control's impact on the overall rental supply, controlled and uncontrolled, is ambiguous.

I recognize that the affordability crisis is fueling the recent crop of new rent control provisions. However, the problem is insufficient household income. Rent control imposes social costs that likely exceed the benefit to the lucky few who find rent controlled units. Moreover, the pernicious impact of rent control worsens over time in the face of increasing excess demand since rent control reduces the absolute and quality adjusted inventory of rental housing.

Rental markets are linked to other markets, including office markets. As noted, rent control impairs labor markets through reduced employment choice and mobility. If firms have difficulty recruiting qualified employees due to a lack of affordable housing, then some firms will relocate to jurisdictions without rent control and, if needed, provide employees with housing subsidies or other compensation.

Rent control distorts resources allocation in any number of ways, including the location decisions of households and firms.

Since rent control reduces the availability of housing, especially poor quality housing, rent control can increase homelessness. Of course, homelessness is a complex social pathology, but lack of income is an important contributing factor that affects access to housing, medical care, food and other essentials. Controls increase the likelihood of conversion of low quality units to non-residential uses, which hurts lower income households. Additionally, when there is excess demand, non-price rationing occurs, as previously mentioned, which gives landlords vast discretion in selecting so-called desirable tenants, and the homeless too often do not qualify.

Markets have memories: New construction is less in markets with a history of rent control or a propensity to adopt controls. The propensity to adopt controls increases the credit spread and reduces the expected growth rate of net operating income, which increases cap rates. Rent control distorts capital flows.

If the goal is to help lower income households, then federal and state governments should use more effective means, such as income tax credits or a negative income tax. When local governments, especially those whose geographic areas are small, attempt to redistribute income, foot-loose, higher income tax payers with their feet, thus depressing the demand for all property, not just for apartments.



Markets react promptly. Pricing (cap rates) react promptly and negatively to the adoption of rent control and positively to the elimination of rent controls. Markets discount the anticipated private costs. However, the slow-to-emerge social costs are very real, long lasting and possibly greater than the private costs.

These observations are not theoretical. Jim Costello of Real Capital Analytics this year reported that during the last year apartment

cap rates in ten out of 12 regulated markets increased. Cap rates rose in only 19 out of 46 uncontrolled markets.

Is it possible to invest successfully in rent controlled apartments? Not all rent controls are alike, and profiting from rent control depends on the details as well as the timing. Consider an example: Rent control operates in the presence of asymmetric information. How can landlords exploit this market imperfection? Landlords prefer to rent to tenants who stay in an apartment for only a short time because the landlord has the option to adjust the rent upward if the tenant leaves. However, tenants have little incentive to reveal their tenancy preference. Some investors have acquired rent-controlled apartments in jurisdictions that permit the reestablishment of market rents when the tenant defaults or vacates. This control is limited to the duration of the tenancy. These investors realize a higher return if more tenants vacate. Hence, landlords may prefer short-staying tenants. The problem is that tenants may have no incentive to reveal their preference for the length of tenancy. Hence, owners are very interested in the age distribution of the tenants. A discerning owner with an eye toward actuarial finance can earn excess returns.

An important observation is that the owner's rent control burden depends in part on when the controls are imposed. If an investor acquires a property with no expectation of rent control, then imposition of rent control reduces the value of the property and the existing owner suffers a potential capital loss. However, when the owner sells the now rent controlled property, the price of the property reflects not just the impact of rent control but also the

market's assessment of tenant rollover. Discerning buyers who can amass actuarially valid private information that is not already discounted into the price of the asset may have a significant edge.

Conclusion. Society through the political process necessarily makes tradeoffs between efficiency and equity, but in reality the world is not a tidy place and practical solutions are often messy. Those who support rent control usually have the best intentions, helping the less well-off. However, good politics is often bad economics and the unintended consequences can be severe. For example, we need more housing, not less, but local land use controls, especially open space and growth restrictions, limit new construction, create excess demand and increase rents. Rent control makes a bad situation even worse.



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Randall Zisler, co-founder of Zisler Capital Associates, LLC, was a professor at Princeton University where he taught economics and finance and earned his A.B., two of his three master degrees and his Ph.D. As head of real estate research at Goldman Sachs & Co. and Nomura Securities, he devised innovative risk-based approaches to portfolio management and structured finance. He was co-head of investment banking at Jones Lang LaSalle, a partner at Pension Consulting Alliance, and CIO to Merv Griffin. He has advised hundreds of institutional investors, testified before the U.S. Congress Ways and Means Committee, and transacted over \$6 billion of real estate. Dr. Zisler has served as an expert witness in ERISA and other real estate matters. He has lectured at Yale, USC, and Harvard, where he served on the Harvard GSD Advisory Board.

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Randall Zisler, co-founder of Zisler Capital Associates, LLC, was a professor at Princeton University where he taught economics and finance and earned his A.B., two of his three master degrees and his Ph.D. As head of real estate research at Goldman Sachs & Co. and Nomura Securities, he devised innovative risk-based approaches to portfolio management and structured finance. He was co-head of investment banking at Jones Lang LaSalle, a partner at Pension Consulting Alliance, and CIO to Merv Griffin. He has advised hundreds of institutional investors, testified before the U.S. Congress Ways and Means Committee, and transacted over \$6 billion of real estate. Dr. Zisler has served as an expert witness in ERISA and other real estate matters. He has lectured at Yale, USC, and Harvard, where he served on the Harvard GSD Advisory Board.

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