Title

The Case for Preserving Costa-Hawkins: Three Ways Rent Control Reduces the Supply of Rental Housing

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A Compromise in Jeopardy

Following decades of strong population growth and persistent underbuilding, California is in the midst of a housing crisis. The statewide failure to keep up with new demand for housing, even through the recent period of rapid economic growth, resulted in a shortage of available housing and rapidly rising housing costs. In particular, apartment rents surged since the end of the Great Recession, and vacancy rates in many California markets fell to historically low levels. Indeed, the lack of housing affordability represents a major hurdle for many residents and is a significant risk for the California economy. Although there are many factors contributing to the difficulties of building adequate new supply, rent control policies, which are often touted as an affordability solution, exacerbate the problem by significantly reducing the supply of rental housing, even as demand continues to rise.

Rent control was first introduced in California in the City of Berkeley in 1972, and was subsequently adopted by several local jurisdictions across the state in the late 1970s, in response to an extended period of rapid inflation and rent increases[1]. While these original rent control efforts sought to temper the rapid rise in housing costs, many ordinances were highly restrictive and reduced the potential income owners could generate from rental properties. As such, over time a large number of property owners chose to convert apartments to other, more profitable uses, and new apartment development became extremely difficult to justify as a viable investment. In response, the Costa-Hawkins Rental Housing Act, enacted in 1995, was a compromise between local and statewide interests that allowed

California Rent-Regulated Laws by Market

City	Year Rent Control First Introduced
Berkeley	1972
Los Angeles	1978
Beverly Hills	1978
Santa Monica	1979
San Jose	1979
San Francisco	1979
Palm Springs	1980
Oakland	1980
Los Gatos	1980
Hayward	1983
East Palo Alto	1983
West Hollywood	1985
Richmond	2016
Mountain View	2016
Alameda	2016

Notes: Rent control was introduced in Santa Rosa from August 2016 to June 2017, but was repealed by ballot initiative in a special election.

Sources: State of California Department of Consumer Affairs, U.C. Berkeley, California Apartment Assoc., Various City Governments for rent control to continue, but placed pragmatic limits on rent control regulations in local jurisdictions. For example, the ordinance in Berkeley previously included "vacancy control," tying property owners to a fixed starting rent and only incremental rent increases over time, even when units turn over from one tenant to another. By contrast, Costa-Hawkins allowed for vacancy "de-control", guaranteeing the ability for property owners to charge market rents upon the vacancy of a rent-controlled unit, thereby providing potential for future income over time. Additionally, Costa-Hawkins ensured that newly built buildings would not fall under rent control, alleviating fears of property owners and developers that cities would impose rent control even on newly constructed properties.

Despite the continued and numerous effects of maintaining local rent control policies over the long term, the limitations that Costa-Hawkins provided eased a number of the most restrictive rules that existed in several cities, which previously made it particularly difficult for property owners to maintain existing properties, or for developers to justify new construction. As a result, construction activity increased in many markets in the years following the Costa-Hawkins legislation. While still insufficient to solve the statewide housing shortage, Costa-Hawkins represented an important step toward maintaining the existing supply of rental units and making the development of new housing supply viable in communities with rent control.

Today, this compromise is in jeopardy. Proposition 10, a statewide ballot initiative in the upcoming November 2018 election aims to repeal the 1995 law. If Costa-Hawkins is repealed, the rules that provided assurances for existing property owners and enabled increased levels of new construction activity will be abolished, and local jurisdictions will be free to enact more restrictive forms of rent control. A return to more rigid rent control laws could severely reduce new construction activity, lead to greater housing scarcity and further increase rents for many households in the coming years.

In order to highlight the significance of why this policy change would be detrimental for the California housing market, it is critical to understand the ways that rent control reduces the supply of rental housing units over time. Specifically, rent control ordinances reduce rental supply in several important ways: 1) Rent control incentivizes property owners to convert rental units to other uses, such as for-sale housing units or non-residential buildings; 2) Rent control reduces the effective supply of available rental units through an inefficient allocation of housing; and 3) Rent control limits the creation of new rental supply by discouraging development activity, especially without guaranteed exemptions for new properties and assurances that property owners can adjust rents to market level upon tenant vacancies. All of these factors combine to decrease the supply of rental housing in markets with rent control, which ultimately lowers apartment availability and raises rents.

As California continues to grapple with an unprecedented housing shortage, an expansion of rent control would create yet another hurdle that would shrink the overall rental housing supply over time and impede the development of new apartment units in ways that are likely to significantly exacerbate the current statewide housing crisis.

Three Ways Rent Control Reduces the Supply of Rental Housing

Rental Conversions Shrink the Number of Available Rental Units

Rent control decreases the supply of rental units by creating incentives for property owners to convert existing apartment buildings to other uses. Policies that limit the amount of rent or the rent increase that can be charged for an apartment unit, effectively decrease the return on investment for property owners by capping the income that the property can produce. Over time, this fundamentally changes the incentive structure for owning rental properties, and pushes property owners to convert existing units to more profitable uses. In particular, property owners may feel compelled to convert apartment units, or buildings, to residential uses that are not subject to rent control, such as condominiums, or to redevelop entire properties to non-residential uses such as office or retail. For smaller, mom-and-pop property owners, some may prefer to leave units that would otherwise be available on the rental market vacant, or to move into rent-controlled units themselves, rather than leasing those units out to tenants. As such, these incentives significantly constrain the existing supply of rental units.

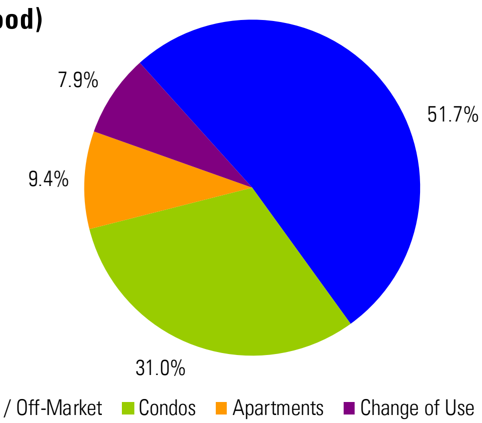
Academic research provides a great deal of evidence for this trend of increased rental conversions for units subject to rent control, both in California and around the country. A recent Stanford University study examined the effects of a 1994 ballot initiative (Proposition I) passed in San Francisco that extended the coverage of the original rent control ordinance to include smaller multifamily buildings with four units or less. In response, property owners converted rental units to single family housing, condominiums or renovated properties into new offerings not subject to rent control. In fact, the Stanford study found that nearly 10% of the properties newly covered by the updated ordinance were redeveloped during the period from 1994 through 2016.[2] Moreover, this study found these properties were 8% more likely to convert to condo or TIC (Tenancy in Common) following the law change. As a result, there was a significant loss of rental supply in San Francisco in direct response to stricter rent control laws.

Numerous studies find similar effects from rent control in other markets around the country. A 2006 Brigham Young University study found that rent control in the Greater Boston area led to an increased number of units converting from rental to owner over time.[3] In particular, the study estimated that from 1990 through 1998, housing units in jurisdictions in Greater Boston with rent controls were 6-7% less likely to be offered for rent, than in jurisdictions without rent control. Moreover, the study estimated that rent control kept thousands of rental units off the market as property owners converted units to for-sale housing. Another report by the City of Berkeley in 1998, which was in favor of rent control, still found that "rent control encourages alternative use of rental space by reducing the opportunity cost of conversion."[4] Indeed, as the cap on rental revenue compounds over time, decreasing the return on investment for rent-controlled properties, alternate uses for existing properties become increasingly appealing investment opportunities. Under these circumstances, it may prove more profitable for owners to remove rental units from the market.

New York City offers a particularly insightful example of the way that rent control can lead to conversions over time. In 1974, New York passed an updated rent control law, which dramatically changed the way existing rent-controlled supply could be taken off the market. One of the allowable ways to decontrol a building, or a collection of units, is for a collective of tenants to opt-in to a co-operative ownership structure. Specifically, a conversion can occur when at least 15% of the occupants of a building opt-in for a co-op conversion.[5] Existing rental tenants must then be offered their units for purchase. Tenants who do not want to buy their unit, may remain in their unit as a renter. However, if rent-controlled tenants vacate their units, the units can then be converted to be part of the co-operative. Largely in response to the limitations of rent control, many property owners leveraged this option to convert units in order to sell off their rental units. Indeed, the number of co-operative units in New York City ballooned to 255,000 units as of 1999, up from 106,000 in 1976, an increase of 140%, with many of these new co-operative units converted from formerly rent-controlled apartment buildings.[6] In New York, the long-term effect of rent control significantly reduced the overall rental supply and dramatically hollowed out the number of units in some neighborhoods, particularly affluent parts of the City.

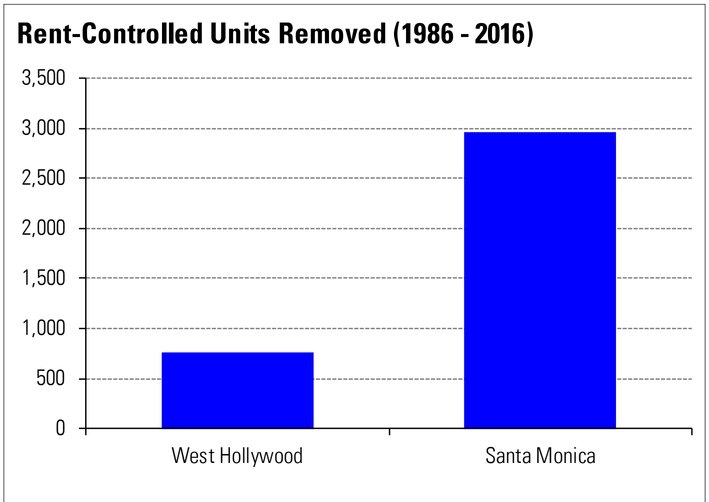
The supply of rent-controlled units also declined in Californian cities since the enactment of rent control, as property owners converted apartment buildings to other uses. In West Hollywood, a review of City records found that from 1986 through 2016, 764 rent-controlled units were removed from the rental market.[7] Nearly 52% of these removed units stayed off the market or were converted to single family homes. An additional 31% were

Conversions of Rent-Controlled Units (West Hollywood)



Source: City of West Hollywood

converted to new or pending condominiums. Less than 10% of all units converted from rent control, were returned to the apartment market as new apartment units. In nearby Santa Monica, a total of 3,042 units were withdrawn from the rental market from 1986 through 2017.[8] During this time, only 1,094 of these units were replaced with new apartment units. Indeed, the slow leakage of rental units due to conversions had significant effects on rental supply in both of these markets, and in many other rent control jurisdictions across the state of California.



Sources: City of West Hollywood, City of Santa Monica

California currently faces a persistent and wide-spread housing shortage. Rent control measures that reduce the potential for rental income over time substantially shift the incentives for property owners. The introduction of rent control laws create an environment where property owners are more likely to convert their rental units to other uses, reducing the number of rental units on the market. As the existing stock of rental units falls, predictable outcomes that would happen in any supply-constrained market ensue. Specifically, rents tend to rise rapidly and low availability becomes a persistent challenge for tenants in search of an apartment. As such, while some households benefit from lower rents, rent control further contributes to the broader problem of housing scarcity in California, as the conversion of rental units to other uses significantly decreases supply.

Inefficient Housing Allocation Increases Scarcity

In addition to conversions, rent control creates unintended consequences that further reduce the supply of rental units through an inefficient allocation of housing, especially over long periods of time. In an environment of scarcity, it is difficult for residents to find new housing and many existing tenants may feel stuck in their units, unable to move or downsize as their housing needs change along with their stage in life. For example, a family household may require a relatively large multi-bedroom apartment today, but will likely require less space later in life once their children reach adulthood and form their own new households. However, for households living in a rent-controlled unit and paying substantially below-market rent, it is significantly less likely that they will be able to find an opportunity to downsize to a smaller unit. The result is a decrease in the total number of people living in the same number of rental units over time.

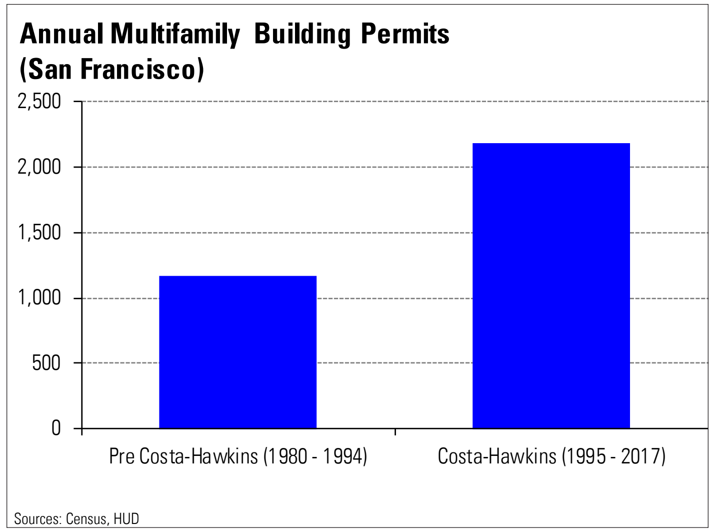
A 1990 Auburn University study provides considerable evidence for this phenomenon. Specifically, researchers found that one-quarter of families in New York City consumed at least 25% more housing under rent control than they would if rent control did not exist.[9] Similarly, research on San Francisco found that there was a 25% reduction in the number of renters living in rent-controlled units during the period from 1994 through 2016.[10] Both cases, exhibit the effects of a prolonged duration of rent control. Indeed, as the inefficient allocation of housing accrues over time, the effective supply of apartment units declines, and cities are faced with a situation where more units are needed to house the same population. While it is an unintended consequence of rent control, in practice, this inefficient allocation of apartment units increases the scarcity of rental housing and amplifies the adverse effects of the statewide housing shortage.

Unrestricted Rent Control Impedes New Construction

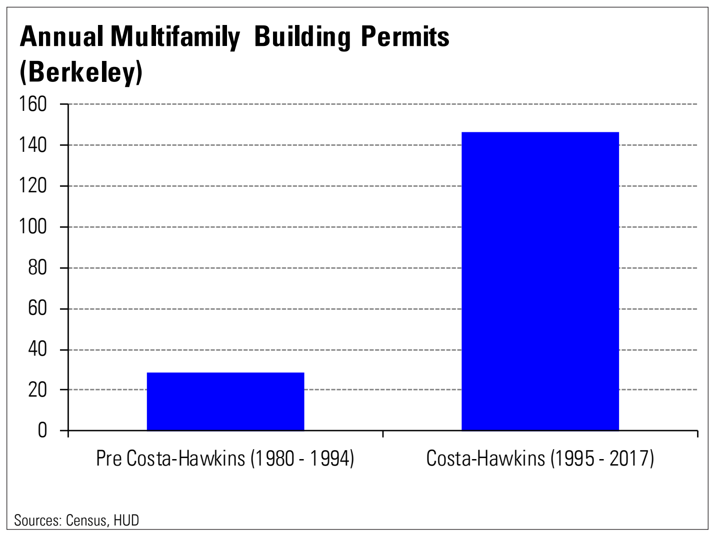
California is a severely undersupplied housing market. During the last decade, statewide deliveries averaged less than 80,000 new housing units annually, compared with the estimate of 180,000 units needed per year to keep pace with household formation, according to the California Department of Housing and Community Development.[11] Persistent low levels of construction reflect a wide range of factors including a combination of high construction costs, restrictive land use zoning, community obstruction and prohibitive or costly regulatory hurdles. Compounding the challenges associated with limited supply additions, rent control further restricts supply through rental conversations from apartments to non-apartment uses and the inefficient allocation of housing.

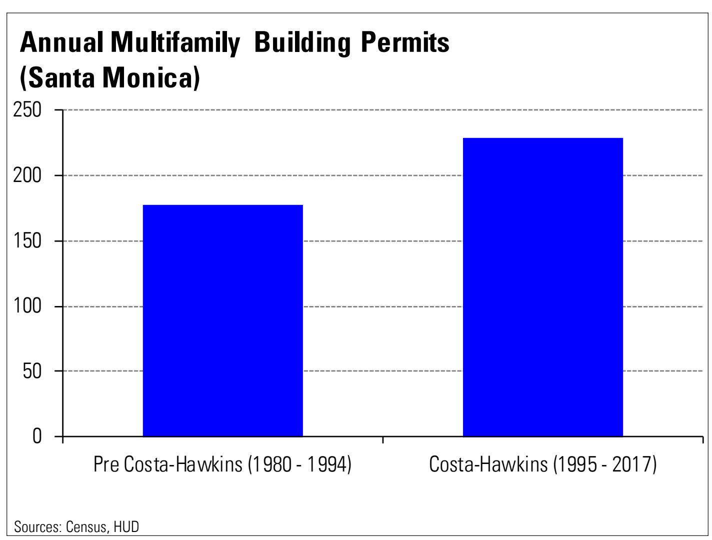
As rent control actively shrinks the rental housing supply, it is critical for developers to add more units through construction activity. However, if rent control were expanded to include newly constructed properties, or even applied to newer properties on a rolling basis based on the building age, such as after 15 or 20 years, these limitations on apartment rents, or on the pace of rent increases, could significantly impact the feasibility of many development projects. Importantly, developers do not build apartment units in a vacuum, they are responsible to their investors to make a reasonable profit, and they are responsible to their lenders to repay development loans. Without sufficient potential for rent and income growth from a property, investors will be hesitant to invest, lenders will be unwilling to lend, and developers will be unable to finance new construction projects.

Currently, Costa-Hawkins prohibits rent control on apartment buildings built since 1995 (or earlier for cities with existing restrictions in place prior to Costa-Hawkins) and establishes vacancy de-control, which ensures the ability for property owners to set new rents after a tenants moves out of a rent-controlled unit. These requirements provide assurances for property owners and new developments in cities across the state, regardless of whether rent control is currently in place. Without these assurances, many investors and lenders could choose to allocate capital to other less risky opportunities, or other regions of the country, creating an environment where new apartment development activity in California could stagnate.



While there are many factors contributing to the pace of new housing construction over time, including broader economic and housing market conditions, the trend in multifamily home permitting activity in California before and after Costa-Hawkins may be illustrative of what could happen if Proposition 10 passes. Several rent control jurisdictions, including San Francisco, Berkeley and Santa Monica, had highly restrictive rent control regimes that were subsequently eased by the enactment of Costa-Hawkins in 1995. From 1980 through 1994, San Francisco permitted an average of fewer than 1,200 multifamily units annually, including both apartment and condominium properties. In contrast, following Costa-Hawkins, construction activity increased considerably to an average of nearly 2,200 units per year from 1995 through 2017.[12] Similar patterns occurred in both Berkeley and Santa Monica, which permitted an annual average of approximately 30 and 180 mul-





tifamily units, respectively, from 1980 through 1994, before ramping up construction to an average of nearly 150 and 230 units, respectively since 1995.

Research on the Ontario, Canada rental market provides further evidence of the potentially significant impact that adopting restrictive rent controls can have on new rental construction. Specifically, a 1988 study from the University of Toronto examined the effects of the Residential Premises Rent Review Act, which implemented rent control in Ontario starting in 1975.[13] The detrimental impact to housing supply in Ontario is most evident when observing the trend in rental housing starts before and after rent control was implemented. Specifically, during the four-year period preceding the adoption of rent control, rental starts averaged more than 36,800 units. In contrast, rental starts dwindled to an average of approximately 14,500 units during the five years that followed. Moreover, starts remained depressed, averaging nearly 13,400 units annually from 1980 through 1986. This dramatic decline in construction starts highlights the way that diminished returns for property owners resulting from rental control regulation, do not adequately incentivize bringing new supply to the market, thereby contributing to a dearth in available rental product for those the regulation aims to serve.

In California, if current statewide limitations were removed, it is likely that a number of jurisdictions across the state would choose to adopt stricter forms of rent control. In particular, the Costa Hawkins protections for new construction and vacancy de-control could be subject to change at the city level. Such actions would dramatically reduce the incentive for investors, developers and lenders to fund new apartment construction, as potential return on investments would immediately be called into question. Additionally, with the uncertainty that each individual jurisdiction could propose new limitations at any time, investors would be unable to determine the scale of their potential risk exposure and would likely shift funds to other less risky and more productive investment opportunities. Moreover, existing property owners would have even greater incentives to turn to alternative uses for their properties. Despite the drawbacks of the current rent control system in California, it is clear that a removal of statewide limitations could drastically slow new construction activity, further exacerbating the critical housing shortage the state already faces.

Conclusion

Amid a critical housing shortage, the compromises that Costa-Hawkins established between local and statewide interests ensured a degree of certainty for the housing market and supported the development of new apartment supply in recent years. Today, however, repealing Costa-Hawkins could create a haphazard patchwork of differing rent control rules in cities across the state. Moreover, the rules in each city could be subject to change at any point in the future, creating untold uncertainty for property owners, investors, lenders and developers. Rent control already reduces existing rental supply through conversions and the inefficient allocation of units. Stricter rent control would further reduce existing rental supply, while also limiting new development, making it even harder to keep pace with population growth and household formation, and exacerbating the challenges of low vacancy rates and rapidly rising rents. The current pace of new construction continues to fall far short of the statewide housing needs, and the last thing California needs is another barrier to building new rental housing. Instead, the best model for the California housing market would be to reduce barriers to construction in order to incentivize new supply and alleviate the perpetual cycle of housing scarcity. Preserving Costa-Hawkins is a critical first step to achieving this goal.

End Notes

Rent Control in Berkeley was in effect from 1972 through 1976, a modified rent control was subsequently re-enacted in 1978 and formally went into effect in 1984.

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