

## REASSESSING RENT CONTROL: ITS ECONOMIC IMPACT IN A GENTRIFYING HOUSING MARKET<sup>1</sup>

As a result of gentrification,<sup>2</sup> many American cities have experienced a sharp decline in the supply of affordable housing for low- and middle-income families, although demand for such housing continues to rise. The resulting increase in rents has left the low-income population "shelter poor"<sup>3</sup> and often displaced or homeless. Rent control, typically proposed as a solution, frequently meets with impassioned opposition. Many of the attacks on rent control center on its economic effects and assert that rent control is both inefficient and counterproductive.

This Note challenges the economic arguments against rent control by exploring the impact of rent control in a gentrifying market. Part I describes a gentrifying housing market. Part II discusses the type of rent regulations that would ameliorate the problems caused by gentrification. Part III challenges traditional economic criticisms of rent control and demonstrates that such criticisms are inapposite in a rapidly gentrifying market. The Note concludes that, in such a market, a rent control scheme serves as an effective partial response to the low-income housing crisis.

### I. AN EXAMINATION OF THE GENTRIFYING HOUSING MARKET

In the past, the primary source of urban housing for the poor has not been new construction.<sup>4</sup> Replacement rents — the rents required

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<sup>1</sup> This rent control proposal was first suggested by Professor Duncan Kennedy, Harvard Law School, and Karl Case, Federal Reserve Bank of Boston. Research for this Note was supported in part by a grant from the John M. Olin Foundation.

<sup>2</sup> Gentrification occurs when the movement of more affluent classes into older, central neighborhoods transforms them, through privately financed rehabilitation, into higher-priced, residential areas. See Note, *Displacement in Gentrifying Neighborhoods: Regulating Condominium Conversion Through Municipal Land Use Controls*, 63 B.U.L. REV. 955, 958 (1983). For a description of this process, see, for example, Durham & Sheldon, *Mitigating the Effects of Private Revitalization on Housing for the Poor*, 70 MARQ. L. REV. 1 (1986).

For studies determining where gentrification is occurring, see Henig, *Gentrification and Displacement Within Cities: A Comparative Analysis*, 61 SOC. SCI. Q. 638, 644-45 (1980); LeGates & Hartman, *Gentrification-Caused Displacement*, 14 URB. LAW. 31, 32 nn.5-8 (1982); Marcuse, *Gentrification, Abandonment, and Displacement: Connections, Causes, and Policy Responses in New York City*, 28 J. URB. & CONTEMP. L. 195 (1985); Smith, *Toward a Theory of Gentrification*, A.P.A.J., Oct. 1979, at 538; and Wright & Lam, *Homelessness and the Low-Income Housing Supply*, 17 SOC. POL'Y 48, 51-52 (1987).

<sup>3</sup> The "shelter poverty" phenomenon is defined as "deprivation of non-shelter necessities resulting from the squeeze between incomes and housing costs." Stone, *Housing and the Economic Crisis: An Analysis and Emergency Program*, in AMERICA'S HOUSING CRISIS 103 (C. Hartman ed. 1983).

<sup>4</sup> See Kennedy, *The Effect of the Warranty of Habitability on Low Income Housing: "Milking" and Class Violence*, 15 FLA. ST. U.L. REV. 485, 486 (1987).

to support new construction — are significantly higher than the costs of providing housing services in existing structures.<sup>5</sup> Without government subsidies, the construction of new low-income housing units remains unprofitable.<sup>6</sup>

In the absence of new construction, low-income housing becomes available to the poor in traditional, nongentrifying housing markets through a filtering process.<sup>7</sup> As the quality of housing declines with age, the demand of the higher-income households “cannot be satisfied by even the best of the standing stock.”<sup>8</sup> This affects the production and allocation of housing in two ways. First, the demand for high-quality housing at the upper-income level stimulates new construction of luxury housing. Second, housing no longer desired by upper-income residents filters down to lower-income consumers. As upper-income occupants vacate existing units, the vacancies increase the supply of housing available for the next income tier, thereby depressing prices. Middle-income families then move into the formerly upper-income homes, and start the process anew. As renters at the lowest level of quality and price “filter up” in the housing market, the least desirable units at the end of the housing chain are abandoned. In this market, then, different income classes generally do not compete for the same housing.<sup>9</sup>

In gentrifying cities, however, several economic factors have combined to change the demand and supply of housing. As a result, the filtering model no longer accurately describes housing production and allocation. In the gentrifying market, upper-income groups displace lower-income groups in existing housing stock, instead of building new homes or moving into homes formerly occupied by wealthier families. The impetus for this “reverse filtering” lies in economic and demographic trends.<sup>10</sup> During the 1970's and 1980's, the aggregate

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<sup>5</sup> Replacement rents depend largely on tax policy, federal monetary and fiscal policy, zoning laws, development and building codes, land prices, and construction costs. See THE REPORT OF THE PRESIDENT'S COMM'N ON HOUSING xx, xxi, 177-237 (1982) [hereinafter COMMISSION]; see also Baar, *Guidelines for Drafting Rent Control Laws: Lessons of a Decade*, 35 RUTGERS L. REV. 723, 726 n.5 (citing Strachota & Shenehon, *Market Rent v. Replacement Rent: Is Rent Control the Solution?*, 51 APPRAISAL J. 89, 93-95 (1983) (estimating replacement rent as less than half of that necessary to provide an incentive for new construction)).

<sup>6</sup> See Turner, *Housing Needed for America's Poor*, 60 J. ST. GOV'T 98, 104 (1987); Weitzman, *Economics and Rent Regulation: A Call for a New Perspective*, 13 REV. L. & SOC. CHANGE 975, 981 (1984-85).

<sup>7</sup> For general discussions and critiques of the filtering theory, see HOUSING IN AMERICA: PROBLEMS AND PERSPECTIVES 161-203 (R. Montgomery & D. Mandelker 2d ed. 1979); Edell, *Filtering in a Private Housing Market*, in READINGS IN URBAN ECONOMICS 204-15 (M. Edell & J. Rothenberg eds. 1972); and Lowry, *Filtering and Housing Standards: A Conceptual Analysis*, 36 LAND ECON. 362 (1960).

<sup>8</sup> Lowry, *supra* note 7, at 364.

<sup>9</sup> See H. AARON, SHELTER AND SUBSIDIES 7 (1972).

<sup>10</sup> See generally Berry, *Islands of Renewal in Seas of Decay*, in THE NEW URBAN REALITY

demand for housing increased as the "baby boom" generation began reaching peak household-formation years<sup>11</sup> and as average household size declined.<sup>12</sup> As new construction costs rose, and as other factors made new suburban homes less desirable than existing urban homes, families seeking new homes no longer looked to newly constructed housing.<sup>13</sup> Land use controls,<sup>14</sup> such as exclusionary zoning ordinances, that either directly prohibited multifamily and other moderately priced housing developments or made development of such units economically infeasible<sup>15</sup> raised the cost of most new single-family homes beyond the means of the middle class.<sup>16</sup> A number of other factors, such as government subsidies and changes in the makeup of families, further reduced the desirability of suburban relative to urban homes.<sup>17</sup>

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69, 75 (P. Peterson ed. 1985); James, *The Revitalization of Older Urban Housing and Neighborhoods*, in *THE PROSPECTIVE CITY* 130, 140-42 (A. Solomon ed. 1981).

<sup>11</sup> See Sternlieb & Hughes, *Housing in the United States: An Overview*, in *AMERICA'S HOUSING: PROSPECTS AND PROBLEMS* 51 (G. Sternlieb & J. Hughes eds. 1980) (estimating a 35% rise in number of people in peak home buying age during the 1970's); James, *supra* note 10, at 144.

<sup>12</sup> See Merriam, *Accessory Apartments*, in 1984 *ZONING AND PLANNING LAW HANDBOOK* 351 (J. Gailey ed. 1984). Smaller households require more space per capita. See Alonso, *The Population Factor and Urban Structure*, in *THE PROSPECTIVE CITY*, *supra* note 10, at 32, 36-37. Thus, even absent a population increase, all other things being equal, smaller household size alone would have led to a dramatic increase in demand.

<sup>13</sup> See A. DOWNS, *RENTAL HOUSING IN THE 1980'S*, at 78 (1983) (asserting that construction of rental units was inadequate to replace those withdrawn from use); see also COMMISSION, *supra* note 5, at xxi, 60, 61; U.S. BUREAU OF THE CENSUS, *STATISTICAL ABSTRACT OF THE UNITED STATES* 704 (1987) (stating that housing starts have dropped dramatically); Gilpin, *Starts in Housing Tumble by 16.2%, Worst in 3 Years*, *N.Y. Times*, Jan. 21, 1988, at 1, col. 6 (same).

<sup>14</sup> Examples include restrictions on density, lot size, and structure size. See Katz & Rosen, *The Interjurisdictional Effects of Growth Controls on Housing Prices*, 30 *J.L. & ECON.* 149, 151-52 (1987).

<sup>15</sup> See Dowall, *The Effect of Land Use and Environmental Regulations on Housing Costs*, 8 *POL. STUD. J.* 277 (1979) (arguing that zoning leads to increased land prices); S. SEIDEL, *HOUSING COSTS & GOVERNMENT REGULATIONS* 159-86 (1978) (discussing types of zoning and their impact on housing costs).

<sup>16</sup> See U.S. DEPT. OF HOUSING AND URBAN DEVELOPMENT, *THE CONVERSION OF RENTAL HOUSING TO CONDOMINIUMS AND COOPERATIVES* i-iii (1980) [hereinafter *CONVERSION*]; Durham & Sheldon, *supra* note 2, at 4.

<sup>17</sup> The widening of the suburban ring away from inner-city jobs and the advent of two-income couples doubled the family's commuting time and made urban housing more desirable. See Alonso, *supra* note 12, at 46-47. Moreover, a reduction in household size and an increase in the proportion of the middle- and upper-income population with no children, see Berry, *supra* note 10, at 81; Comments, *The Condominium Conversion Problem: Causes and Solutions*, 1980 *DUKE L.J.* 306, 308, n.14 (1980), diminished the value of open spaces and good public school systems associated with suburban life. See Alonso, *supra* note 12, at 48; Lipton, *Evidence of Central City Revival*, 43 *J. AM. INST. PLANNERS* 136 (1977); Sumka, *Neighborhood Revitalization and Displacement: A Review of the Evidence*, 45 *J. AM. PLAN. ASSOC.* 480 (1979). After 1970, the development of condominium and cooperative forms of tenure allowed a growing segment of the population who preferred home ownership to move into existing multifamily

Because existing urban housing has become more desirable to middle- and upper-income families, these families have begun to bid for units rather than buying new ones. In gentrifying neighborhoods, the higher-income newcomers have more money to spend on housing, allowing them to outbid current residents.<sup>18</sup> This "reverse filtering" process displaces lower-income tenants living in inner-city neighborhoods by increasing the price of rental housing and by depleting the supply of low-income apartments in two ways.

First, landlords have an incentive to convert their rental units to condominiums for wealthier newcomers.<sup>19</sup> This directly displaces low-income tenants and increases rental prices by reducing supply. As wealthier consumers convert low-income rentals to condominiums or luxury housing, and as little new low-income housing is built, the supply of low-income rental units decreases, driving up rental prices.<sup>20</sup>

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dwellings rather than suburban single family homes, thus capturing tax advantages of home ownership. See Muth, *Effects of the U.S. Tax System on Housing Prices and Consumption*, in *THE URBAN ECONOMY AND HOUSING* 11 (R. Grieson ed. 1983); H. Hansmann, *The Law and Economics of Cooperative and Condominium Housing* 4, 6 (1986) (unpublished manuscript on file with the Harvard Law School library) (describing the development of the condominium form of tenure).

Finally, some local governments subsidized the gentrification process by granting subsidized loans, directing federal grants to private developers working in gentrifying neighborhoods, and giving tax benefits to gentrifiers. See *TASK FORCE ON RENTAL HOUSING: HEARINGS BEFORE THE SUBCOMM. ON HOUSING AND COMMUNITY DEVELOPMENT OF THE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS*, 96th Cong., 2d Sess. 465-73 (1980); Marcuse, *supra* note 2, at 212-213, 228.

<sup>18</sup> The typical new owner in a gentrified neighborhood is a young white person whose income falls somewhere in the middle to upper end of the income range — well above the urban and metropolitan area medians and the income of the displaced residents. See LeGates & Hartman, *supra* note 2, at 36-37.

<sup>19</sup> See Baar, *supra* note 5, at 837 (noting that the value of a condominium unit is usually at least double that of the same unit as a rental); see also Hansmann, *supra* note 17, at 40 (calculating tax savings earned on condominium conversion). Federal tax code provisions encourage this process; although the federal tax code permits certain deductions to both owner-occupiers and landlords, see 26 U.S.C. § 164(a)(1) (deductions for state and local real property taxes); 26 U.S.C. § 163(a) (deduction for interest paid on mortgage liabilities), home owners are not taxed on the imputed rental value of owner-occupied housing. See Muth, *Redistribution of Income Through Regulation in Housing*, 32 *EMORY L.J.* 691, 699-700 (1983). The value of this subsidy is offset somewhat by the landlord's ability to deduct depreciation, but the value of the exclusion of imputed rental income is larger. See Hansmann, *supra* note 17, at 26-42.

<sup>20</sup> See Note, *supra* note 2, at 961. Nationwide data indicate that the supply of low-cost housing is decreasing at a growing rate. See Morganthau, Cohn & Anderson, *The Housing Crunch*, *NEWSWEEK*, Jan. 4, 1988, at 18 [hereinafter Morganthau]; Wright & Lam, *supra* note 2, at 51 (finding a net average of 360,000 rental units lost annually between 1974 and 1979 due to arson, abandonment and gentrification); see also R. GOETZE, *UNDERSTANDING NEIGHBORHOOD CHANGE* 103 (1979); Wright & Lam, *supra* note 2, at 52 (arguing that determining the exact number lost to gentrification alone is difficult because sometimes arson and abandonment are caused by gentrification.)

The decline in supply has caused a shortage of low-income housing. See Morganthau, *supra*, at 18 (finding that the national gap between supply and demand at 1 million units for rentals

Because government subsidies supporting the only low-income housing construction have declined greatly since 1980,<sup>21</sup> these lost units go largely unreplaced.<sup>22</sup> Second, even when apartments are not converted, gentrification indirectly displaces tenants through rent escalation. As the average income of families demanding housing in a neighborhood rises, landlords raise the rents of existing tenants to reflect the higher rents newcomers are willing to pay.<sup>23</sup>

Once gentrification has sparked higher housing prices, anticipation of even greater capital gains can generate explosive price increases. In large measure, the basic forces of supply and demand, such as population growth, employment, income distribution, taxes, interest rates, and fuel and construction costs, determine housing prices.<sup>24</sup> In a market characterized by gentrification, however, housing prices may rise more than these market fundamentals would predict.<sup>25</sup> If investors expect demand to continue to propel housing prices upward, they may engage in bidding that drives up prices and fulfills their expectations. If they then revise their expectations to reflect actual price behavior, they set the stage for another expectation-based price increase.<sup>26</sup>

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that cost no more than \$250 a month); Wright & Lam, *supra* note 2, at 51 (finding the number of low-income units to have declined thirty percent from the late 1970's to early 1980's whereas the number of poor increased thirty-six percent).

<sup>21</sup> The Reagan administration has decreased spending on low-income housing from \$25 million per year to less than \$8 million. See Morgenthau, *supra* note 20, at 18. Under Presidents Ford and Carter, the federal government built or rehabilitated an average of 200,000 units per year. Under Reagan, that figure has dropped to 27,000 in 1986. See Dukakis, *States Take a Fresh Look at Housing*, 60 J. ST. GOV'T 95, 96 (1987). The number of publicly owned housing starts has dropped from 20,000 in 1980 to 3000 in 1985 with only 6400 currently under construction; the total number of low-income public housing units has decreased from 1,432,200 in 1982 to 1,373,700 in 1985. See U.S. BUREAU OF THE CENSUS, *supra* note 13, at 704, 717. In addition, the Tax Reform Act of 1986 eliminated most of the special tax treatment of investments in low-income housing and reduced the volume of tax exempt bonds that states and localities can issue to fund their housing programs. See Edgar & Matulef, *Public Housing: Can We Keep Up What We Have?*, 60 J. ST. GOV'T 137, 138 (1987).

<sup>22</sup> See Durham & Sheldon, *supra* note 2, at 12.

<sup>23</sup> See Gilderbloom, *An Analysis of Intercity Rents*, in *THE RENT CONTROL DEBATE* 75, 83, 87-88 (P. Neibanck ed. 1985).

<sup>24</sup> See Case, *The Market for Single-Family Homes in the Boston Area*, *NEW ENG. ECON. REV.*, May-June 1986, at 41-44.

<sup>25</sup> See *id.* at 45. Case formulated the speculative bubble market theory described at p. 1840 below. His theory and results are described in Case, cited in note 24 above; Case & Shiller, *Prices of Single Family Homes Since 1970: New Indexes for Four Cities*, *NEW ENG. ECON. REV.*, Sept.-Oct. 1987, at 45; and K. Case & R. Shiller, *The Efficiency of the Market for Single Family Homes* (December 10, 1987) (paper presented at the American Finance Association on file at the Harvard Law School Library).

For a discussion on speculation, see C. KINDLEBERGER, *MANIAS, PANICS AND CRASHES* (1978), and Feagin, *Urban Real Estate Speculation in the United States*, in *CRITICAL PERSPECTIVES ON HOUSING* 99 (R. Bratt, C. Hartman & A. Meyerson eds. 1986).

<sup>26</sup> See Case, *supra* note 24, at 45.

The housing market is more likely than other markets to generate price "bubbles" because information about the "fundamental" yield of housing is difficult to obtain. Because housing is a heterogeneous commodity, the cost of which reflects the prices of a wide range of goods and services, consumers must rely on "expert" opinions to estimate the value of potential purchases. However, these experts, particularly real estate brokers, have incentives to create expectations of future increases in order to make greater profits.<sup>27</sup>

The increases in the price of housing triggered by gentrification and fueled by speculation represent economic rents attributable to land.<sup>28</sup> The price of housing includes the value of the initial capital investment, improvements, and maintenance, and the value of land on which the housing is located. In gentrifying cities, the rapid increases in the price of housing have occurred in periods when capital and labor costs have remained relatively constant. Instead, of being caused by increases in these costs the price escalation reflects an increase in the revenues derived from the ownership of land.<sup>29</sup> Land differs from other housing price determinants because its supply is fixed, regardless of the price. Thus, current demand and expectations of future increases in the value of land determine the price completely, and any return on land is by definition economic rent.<sup>30</sup>

The higher rents caused by gentrification and land speculation can exacerbate already large rent-to-income ratios for poor tenants, resulting in an inadequate supply of food, clothing, and other necessities.<sup>31</sup> Displacement imposes additional hardship.<sup>32</sup> The luckiest of

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<sup>27</sup> See *id.*

<sup>28</sup> See R. GOETZE, *RESCUING THE AMERICAN DREAM* 30 (1983); C. HARTMAN, D. KEATING & R. LEGATES, *DISPLACEMENT: HOW TO FIGHT IT* 46-47 (1982) [hereinafter *DISPLACEMENT*]. Economic rent is "any payment over and above what is necessary to maintain a factor of production in its current activity." R. MILLER, *INTERMEDIATE MICRO-ECONOMICS* 407 (1978).

<sup>29</sup> Since the 1970's "[l]and has become an increasingly important component in the total cost of housing." COMMISSION, *supra* note 5, at 60; see also Case, *supra* note 24, at 38-39, 42, 44 (discussing rising relative cost of housing components in Boston).

<sup>30</sup> See B. SCHILLER, *THE ECONOMY TODAY* 757 (3d ed. 1986).

<sup>31</sup> More than 10 million renter households paid 35 percent or more of their income for rent in 1983; 6.3 million paid 50 percent or more, and 4.7 million paid 60 percent or more. See R. BRATT, C. HARTMAN & A. MEYERSON, *CRITICAL PERSPECTIVES ON HOUSING* xiv (1986). In Boston in the years 1984 through 1985, 54 percent of renting families paid at least 25 percent of their income for housing, and almost 80 percent of families with income under \$15,000 paid at least half of their incomes as rent. See BOSTON REDEVELOPMENT AUTHORITY, *BOSTON AT MID-DECADE: RESULTS OF THE 1985 HOUSEHOLD SURVEY, V. CHARACTERISTICS OF HOUSING UNITS* 44 (1986); see also Stone, *supra* note 3, at 102-05 (stating that a family of four with income under about \$23,000 (adjusted for inflation) and spending 25% of income on rent would be unable to purchase the minimum amount of nonshelter necessities in 1984).

<sup>32</sup> A recent national study shows unwanted displacement responsible for 5% of all residential moves in urban areas, representing 2.5 million displaced persons each year. See Wright & Lam, *supra* note 2, at 52; see also Durham & Sheldon, *supra* note 2, at 13 (quoting surveys estimating

the displaced suffer only the economic losses of moving to other housing, for which most pay higher rents.<sup>33</sup> Others also suffer serious psychological harm when uprooted from homes and neighborhoods with which they have developed strong ties.<sup>34</sup> These detrimental effects are felt most severely by poor and elderly tenants,<sup>35</sup> a disproportionate number of whom are displaced.<sup>36</sup> Increased rents make it impossible for some urban residents to afford *any* available housing. Forced to choose between feeding their families and paying the rent, many are driven into the streets.<sup>37</sup> More and more frequently, these "new" homeless, who simply cannot afford housing, include the most vulnerable members of society. Children represent the fastest growing sector of the homeless population: five hundred thousand of the estimated two to three million homeless in America are children.<sup>38</sup>

## II. NECESSARY ELEMENTS OF A RENT CONTROL ORDINANCE

This Note proposes a regulatory scheme combining rent control, a warranty of habitability, eviction restrictions, a moratorium on condominium conversion, and residential zoning restrictions.<sup>39</sup> The term "Rent Control" is used throughout this Note to refer to this full array of housing regulations. Of course, some of these provisions already exist in various jurisdictions; however, the full scheme is necessary to ensure rent control's efficacy in a gentrifying market. This Rent Control proposal will prevent displacement and ameliorate shelter poverty by allowing poor tenants to stay in their units at approximately the current real rent.

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between 1.17 million and 2.4 million people displaced in 1979); Marcuse, *supra* note 2, at 206 (discussing difficulty in calculating accurate figures).

<sup>33</sup> Studies of gentrification-driven displacement demonstrate an increase in shelter costs. See LeGates & Hartman, *supra* note 2, at 47, 48.

<sup>34</sup> See *Comments*, *supra* note 17, at 320; Note, *supra* note 2, at 960 n.40, 961.

<sup>35</sup> See SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, S. REP. NO. 871, 95th Cong., 2d Sess. 49, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 4773, 4822; Stegman & Holden, *States, Localities Respond to Federal Housing Cutbacks*, 60 J. ST. GOVT 110, 114 (1987) (quoting the Raleigh, North Carolina Housing Task Force Report of April 1986).

<sup>36</sup> See Legates & Hartman, *supra* note 2, at 41, 42, 44; Marcuse, *supra* note 2, at 198-99; Wright & Lam, *supra* note 2, at 52.

<sup>37</sup> See J. KOZOL, *RACHEL AND HER CHILDREN* (1988); Wright & Lam, *supra* note 2, at 49-51; Scondras, *Condo Conversion*, Feb. 18, 1986, at 4 (response letter of city councilman David Scondras).

<sup>38</sup> See J. KOZOL, *supra* note 37, at 3.

<sup>39</sup> This proposal is not a complete solution to the housing crisis. Without an expanded stock of housing there will be a continuing gap between need and supply. Also, without greater equality of incomes there will still be families unable to afford even the lower prices available under rent control.

Under Rent Control,<sup>40</sup> the rent level would be set to eliminate only increases in economic rents. Thus, rent levels would reflect reasonable increases in capital and services. Investors would be allowed a reasonable return on capital and full compensation for maintenance expenses, but they would not receive as income that part of the rent that reflects the scarcity of their housing.<sup>41</sup>

Rent Control would include additional provisions designed to prevent circumvention of rent level regulations. Owners, for example, still might seek higher profits by decreasing maintenance. A warranty of habitability would prevent landlords from decreasing the quality of the housing to recapture economic rents in two ways. First, landlords could raise rents in response to increases in costs only if they had adequately maintained the rental unit.<sup>42</sup> Second, tenants would be able to withhold a percentage of the rent for apartments that failed to satisfy the warranty of habitability or for reductions in living space or services. The proposal does not include vacancy decontrol, which would allow the rent to rise to market level whenever a tenant moved, because decontrol encourages tenant harassment and provides disincentives for landlords to maintain housing units satisfactorily.<sup>43</sup>

To prevent involuntary displacement, Rent Control would prohibit evictions in the absence of good cause.<sup>44</sup> However, the housing regulation described would not be effective if wealthier consumers could still outbid poorer consumers by purchasing former rental units that had been converted into condominiums.<sup>45</sup> Thus, the proposal would limit condominium conversion to prevent displacement.<sup>46</sup> Residential

<sup>40</sup> For a guide to drafting an effective rent control ordinance, see Baar, cited above in note 5.

<sup>41</sup> One appropriate method of establishing the proper level of rent is to set rent as the sum of three components: operating expenses, capital recovery, and fair net operating income. See H. LEONARD, *REGULATION OF THE CAMBRIDGE HOUSING MARKET: ITS GOALS AND EFFECTS* 79-80 (1981). Rent adjustments should be allowed for all reasonable, documented, maintenance cost increases, with indexing for inflation; landlords already maintain records of these expenditures for tax purposes. This procedure assures a fair capital recovery by allowing landlords to amortize documented, allowable capital expenditures according to the prevailing market interest rate on similar risk investments. Such a scheme would allow landlords to receive a competitive return on further investments in their buildings, so long as those investments were limited to functional repairs and not used to upgrade the buildings to luxury apartments. See *Mayo v. Boston Rent Control Adm'r*, 365 Mass. 575, 580-81, 314 N.E.2d 118, 122 (1974). Finally, the fair net operating income can be set equal to a "base year" net income on the building that acts as a ceiling on the economic rent. This amount would provide the cash flow for the landlord to pay for maintenance. As of 1983, this and similar plans for setting rent levels were estimated to be in place in 60% of rent-controlled units in the United States. See Baar, *supra* note 5, at 785.

<sup>42</sup> See Baar, *supra* note 5, at 831-32. (describing the mechanism).

<sup>43</sup> See *id.* at 837 n.34.

<sup>44</sup> See *id.* at 833.

<sup>45</sup> See *Flynn v. City of Cambridge*, 383 Mass. 152, 159, 418 N.E.2d 335, 339 (1981).

<sup>46</sup> For a description of types of condominium conversion regulations, see Baar, cited above in note 5, at 835-38.

zoning restrictions would prevent landowners from switching from residential to commercial uses in an attempt to achieve greater economic rents, and still other safeguards could be used to prevent circumvention of the rent price regulation and condominium conversion restraints.<sup>47</sup>

The demand for housing that cannot be met by the current housing stock must be met by an increase in new construction. Thus, to provide an incentive to build, the Rent Control proposal would exempt housing built on previously vacant or commercial land from its provisions. This exemption would not be available to landlords who demolished their buildings to replace them with new housing.<sup>48</sup>

### III. HOW RENT CONTROL WORKS IN A GENTRIFYING MARKET

This Part examines how the proposed Rent Control scheme would affect a market with rising economic rent values fueled by speculative price bubbles and gentrification. In a gentrifying market, lower-income tenants are directly displaced through condominium conversion and are indirectly displaced by the rise in rents caused by the resulting reduction in supply. Even without conversion, higher-income individuals can bid up rents by increasing the demand for available units. Taken together, these price increases often trigger speculative price spirals. By maintaining rental prices at a reasonable level and by

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<sup>47</sup> Without means testing, which this proposal omits because of high administrative cost, some seepage of apartments to wealthier people will occur over time. Some studies, however, suggest that the vast majority of apartments will remain occupied by tenants in the same economic class as the original tenant. Cambridge, Massachusetts is an example of the principle. Cambridge imposed rent control in 1971 and in 1987 70% of all households in rent-controlled units had incomes below the median for all housing. See ABT ASSOCIATES, CAMBRIDGE HOUSING STUDY: FINAL REPORT 15 (1987); see also Leonard, *supra* note 41, at 65, 69 (giving different data on percentage of low-income households living in and moving into rent-controlled apartments in Cambridge). This occurs because most apartments are transferred through an informal market to friends of tenants, who are usually in the same socioeconomic class. Landlords permit and prefer this method because resort to advertising and to interviewing new tenants is risky and costly. The risk can be reduced and the cost eliminated by choosing the friend of a good tenant who is leaving. Landlords also may prefer not to have means testing because it limits their choice of tenants and requires further dealings with an administrative process.

The proposal also must include some disincentive for the creation of a black market. By allowing the tenant to collect a substantial fine and the overcharge from the landlord or to withhold that amount from rent, the system can provide the tenant with an incentive to report overcharges and the landlord with an incentive not to seek them. See, e.g., 1976 Mass. Acts ch. 36, *An Act Enabling the City of Cambridge to Continue to Control Rents and Evictions*, §11. Little seepage is likely to occur because it is less likely under Rent Control that wealthier tenants will want to move into the vacant units. Because landlords have no financial incentive to provide luxury units, and because the tax benefits and investment potential of a condominium in a gentrifying neighborhood are unavailable, wealthier groups will prefer ownership or uncontrolled new rental stock to rent-controlled units.

<sup>48</sup> See Baar, *supra* note 5, at 838-40.

preventing direct displacement, Rent Control will slow the reduction in low-income housing currently occurring in gentrifying neighborhoods.

Traditional economic critiques of rent control fail on a number of grounds. There is no proof that the Rent Control regime proposed will cause the reduction in supply or allocational inefficiencies attributed to rent control in other markets.<sup>49</sup> The critiques are based on assumptions about the provisions for low-income housing described by the traditional filtering model that do not hold true in a gentrifying market. Moreover, some arguments assume inaccurately that the current market is efficient. Third, economic critiques often focus simply on rent regulation, which makes up only one component of the comprehensive scheme described in this Note, or focus on a different type of rent regulation. The omission or alteration of any one portion may critically undermine the effectiveness of the proposal.

#### A. Supply Effects

The benefits of halting the decline of low-income housing supply would be transitory if the imposition of rental price controls resulted in a net long-run reduction in the supply of low-income housing. According to standard economic analysis, rent control reduces the long-term supply of *existing* low-income housing in three ways. First, traditional analysis argues that landlords may respond to lower returns by abandoning their units.<sup>50</sup> Second, it is claimed that rent control leads to a decline in housing services, and ultimately supply, by giving landlords an incentive to maintain their properties inadequately.<sup>51</sup> Third, traditional economic arguments suggest that lower profits induce landlords to convert rental units to more lucrative uses.<sup>52</sup> Moreover, critics suggest that rent control diminishes the *future* supply of new housing because the mere prospect of limits on rental price chills the construction of housing.<sup>53</sup> According to this view, such a disincentive would be magnified in the market for low-income housing, the provision of which is already less profitable.

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<sup>49</sup> For examples of economic criticisms, see COMMISSION, cited in note 5 above, at 91-94; C. BAIRD, *RENT CONTROL: THE PERENNIAL FOLLY* 57-69 (1980); M. LETT, *RENT CONTROL: CONCEPTS, REALITIES AND MECHANISMS* 44-48 (1976); *RENT CONTROL: MYTHS & REALITIES* (W. Block & E. Olsen eds. 1981); and Navarro, *Rent Control in Cambridge, Mass.*, PUB. INTEREST, Winter 1985, at 83.

<sup>50</sup> See, e.g., COMMISSION, *supra* note 5, at 92.

<sup>51</sup> See, e.g., M. LETT, *supra* note 49, at 45-46, 151; Hirsch, *From "Food for Thought" to "Empirical Evidence" About Consequences of Landlord-Tenant Laws*, 69 CORNELL L. REV. 604, 611 (1984); Muth, *supra* note 19.

<sup>52</sup> See, e.g., Muth, *supra* note 19, at 695.

<sup>53</sup> See, e.g., A. DOWNS, *supra* note 13, at 36-37; Fallis & Smith, *Uncontrolled Prices in a Controlled Market: The Case of Rent Controls*, 74 AM. ECON. REV. 193, 196 (1984); Hirsch, *Landlord-Tenant Laws and Indigent Black Tenants*, 10 RES. L. & ECON. 129, 138 (1987).

The imposition of rental price controls undeniably lowers landlords' profits, but several aspects of the Rent Control proposal together prevent investors in the housing market from reducing the supply of existing housing in response. Rather than chilling new construction, in a gentrifying market the Rent Control proposal advanced in this Note is likely to *encourage* housing construction.

The Rent Control package permits landlords a fair return on their initial investment in land and capital, and denies only subsequent escalations in the rental price of land. Because Rent Control applies only to the housing stock existing at the time of adoption, and because the long-run supply of new housing is not affected by Rent Control provisions in any way, the proposal only removes economic rents on a fixed supply of current housing. The effect, then, will be a decrease only in price, not in supply.<sup>54</sup> If investors were denied economic rents on all land, there would be no incentive for landlords to reduce the supply of housing over the long term through conversion, abandonment, or reduced maintenance. Thus, because the only land under Rent Control that could not receive economic rents is that which currently holds a residential structure, Rent Control requires additional measures to ensure that the current stock remain.

Landlords cannot convert their existing rental property to other uses because the Rent Control proposal directly prohibits condominium conversion and conversion of the land to nonresidential uses.<sup>55</sup> Moreover, because landlords are permitted a reasonable return above and beyond costs and are denied only economic rents,<sup>56</sup> they have no incentive to abandon the property. If a landlord continues to operate a property, she will receive a return comparable to other investments with similar risk. If, on the other hand, she abandons the property, her return will be zero, or even negative if she cannot avoid paying property taxes and other fixed costs.

Rent Control creates no disincentives to providing maintenance because it permits landlords to recover maintenance costs. Instead, in a market beset by gentrification and speculative price bubbles, Rent Control creates incentives to maintain housing over and above those generated by the market. Initially, when values increase more rapidly than rents, landlords often choose to finance acquisitions by heavily mortgaging their current holdings, leaving few liquid funds available

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<sup>54</sup> Henry George wrote that, because the supply of land is perfectly inelastic, one could set a tax that would only reduce economic rents without reducing the supply of that factor. See H. GEORGE, *PROGRESS AND POVERTY* (1879). Economists have accepted that economic insight as true for any factor that has a fixed supply. See, e.g., R. MILLER, *supra* note 28, at 408-10; P. SAMUELSON, *ECONOMICS* 526-30 (11th ed. 1980).

<sup>55</sup> Rent control has never been shown to be a significant cause of the increased rate of condominium conversions. See *CONVERSION*, *supra* note 16, at ii.

<sup>56</sup> See *supra* p. 1842.

for maintenance.<sup>57</sup> At the same time, the market fails to exert complete countervailing pressure on landlords to maintain their property. In tight, gentrifying housing markets, landlords can lease units regardless of their condition.<sup>58</sup> This incentive is exacerbated when the landlord plans to sell the building later as individual condominiums. Because individual purchasers are less likely to inspect the entire building adequately, a landlord can reduce current maintenance expenses without lowering his expected future gain upon sale.<sup>59</sup>

Rent Control, on the other hand, removes incentives to undermaintain property.<sup>60</sup> By imposing a ceiling on rents, and preventing conversion, Rent Control eliminates quick capital gains, thereby discouraging speculation by landlords and making financing of such projects less attractive to lenders. Although the tight housing market still allows the landlord to lease the unit regardless of its condition, the proposal enables tenants to police against this source of undermaintenance directly by withholding rent on undercode apartments. By reporting undermaintenance, tenants can also disqualify landlords from receiving generally allowed rent increases. Thus, the landlord is fully reimbursed if she maintains the apartment and will lose money if she does not, a situation creating every incentive to provide adequate maintenance.<sup>61</sup> Furthermore, when the building is sold, it must be sold to a new landlord rather than to individual condominium owners. The purchaser of the entire building will be better able to uncover the effects of poor maintenance, thereby increasing the current landlord's incentives to maintain. The effect of Rent Control on the existing housing supply in the long term, then, is to increase the supply of low-income housing, because Rent Control arrests the depletion of supply caused by gentrification and price spirals without creating incentives to reduce current supply.

Rent Control will also have little negative impact on the future supply of low-income housing. Because Rent Control does not impose any regulation on new construction, it creates no economic incentive to reduce building. Critics argue, however, that rent control will depress new housing starts because investors will fear that controls may be extended someday to those projects.<sup>62</sup> There is no empirical

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<sup>57</sup> See Baar, *supra* note 5, at 738-39.

<sup>58</sup> See R. GOETZE, *supra* note 20, at 34; Baar, *supra* note 5, at 738-39.

<sup>59</sup> See Hansmann, *supra* note 17, at 24-25 (suggesting that condominium markets may exhibit some of the characteristics of "lemons" markets); see also Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (discussing "lemons" markets).

<sup>60</sup> See Baar, *supra* note 5, at 737-39.

<sup>61</sup> See Achtenberg, *The Social Utility of Rent Control*, reprinted in HOUSING URBAN AMERICA 459, 469-70 (J. Pynoos, R. Schafer & C. Hartman 2d ed. 1980); Weitzman, *supra* note 6, at 984.

<sup>62</sup> See *supra* note 53.

evidence, however, that a rent control regime permitting pass-through of maintenance costs and exempting new construction has a chilling effect on future supply.<sup>63</sup>

Even if Rent Control were to chill future construction, it is unclear whether it would decrease the future supply of *low-income* housing. Rent Control does not directly affect incentives for low-income rental construction, because in the current market it is already uneconomical to construct such projects. Under current market conditions, construction of low-income housing occurs only as a result of government subsidies that lower the effective costs of production, or inclusionary zoning programs that force developers to allocate a certain portion of project space or profits to low-income housing.<sup>64</sup> A change in the rental price available on the existing stock affects neither of these types of programs.<sup>65</sup> Nor will Rent Control impede indirect provision of low-income housing as it has traditionally occurred — through downward filtering.<sup>66</sup> By definition a gentrifying housing market inadequately provides low-income housing through downward filtering. In short, the imposition of Rent Control cannot deter what is not occurring.

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<sup>63</sup> See Achtenberg, *supra* note 61, at 468. Although some studies purport to show a decline in construction after the imposition of rent control, they fail to explain why identical trends are found in non-rent controlled cities. See Weitzman, *supra* note 6, at 979; M. Mandel, Does Rent Control Make Tenants Better Off? 37-38 (July 1986) (unpublished manuscript on file at the Harvard Law School library); see also Baar, *supra* note 5, at 759 n.135 (arguing that it is virtually impossible to isolate the effect of rent control alone on construction of new apartments because construction is so dramatically impacted by other factors).

Also, many of these studies examined the effects of earlier types of rent control schemes that, unlike the present proposal, do not permit a competitive rate of return on investment. The traditional supply analysis presumes that "when the cost of providing housing services increases . . . rent control ordinances can prevent landlords from passing on part of these cost increases to tenants." Hirsch, *supra* note 51, at 609. First-generation rent-control ordinances resembled price freezes and prevented pass-through of costs. Contemporary rent regulation or moderate rent control, in contrast, permits a fair and reasonable return on investment, pass-throughs of operating costs, and exemptions from control on all new multifamily construction. See Weitzman, *supra* note 6, at 985; *supra* pp. 1842-43. For a description of rent control past and present, see generally M. LETT, cited in note 49 above, and Blumberg, Robbins & Baar, *The Emergence of Second Generation Rent Controls*, 8 CLEARINGHOUSE REV. 240 (1974).

Evidence that rent control schemes that exempt new housing from control decrease construction is "at best inconclusive." Weitzman, *supra* note 6, at 979. Indeed, in a gentrifying market, Rent Control probably will increase construction. See *infra* pp. 1847-48.

<sup>64</sup> See Tegeler, *Developer Payments and Downtown Housing Trust Funds*, 18 CLEARINGHOUSE REV. 679, 680-84 (1984).

<sup>65</sup> The tenuous connection between rental prices and the quantity of rental housing supplied may not be restricted to the low end of the market. Higher rents may produce no increase in construction in the middle- and upper-income rental market. Replacement rents are significantly above market rents at all levels of the market. See *supra* note 5. Thus, an increase in market rents will only generate excess profits, because new construction is inhibited by its prohibitive cost. See Weitzman, *supra* note 6, at 981.

<sup>66</sup> See, e.g., Hirsch, *supra* note 53, at 138 (explaining that much low-income housing exists because of downward filtering).

Rather than chilling the construction of new housing, in a gentrifying market Rent Control may result in *more* new construction. In a gentrifying market, middle- and upper-income consumers satisfy their demand for housing partially through new construction and partially through movement into existing low-income housing. In a market characterized by downward filtration of housing, displaced low-income families cannot afford newly constructed housing. Those families unable to gain access to the decreasing supply of existing housing must either move in with others or remain homeless. In a market under Rent Control, however, upper- and middle-income consumers will no longer be able to outbid lower-income consumers for existing housing. Thus, although the number of people seeking new housing remains the same, in a controlled market a larger proportion of those consumers whose demand is not met by the existing housing stock will have incomes sufficient to afford newly constructed housing. By forcing consumers to seek alternatives to the current housing stock, Rent Control will keep the current supply from those consumers who can afford new housing. This will probably result in more new construction than would exist in an uncontrolled, gentrifying market.

#### B. Allocational Effects

Critics often argue that rent control is inefficient.<sup>67</sup> First, critics contend that rent control causes misallocation of housing space because below-market rents encourage renters to "waste" space.<sup>68</sup> This argument assumes that in the current market people use housing efficiently, by moving to smaller apartments or doubling up as rents rise, whereas under rent control, tenants respond to lower rental prices by failing to conserve space. Second, critics assert that capital investment is misallocated either because landlords are forced to retain capital in less lucrative residential property rather than in its highest valued use, or because landlords remove residential units from the market when they would prefer to maintain their investment in resi-

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<sup>67</sup> In this Note the phrase "economic efficiency" means "that allocation of resources which could not be improved in the sense that a further change would not so improve the condition of those who gained by it that they could compensate those who lost from it and still be better off than before." Calabresi & McLamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1094 (1972). This conception of efficiency is variously called the "Kaldor-Hicks criterion," the "potential Pareto superiority test," and the "wealth maximization criterion." See Bebchuk, *The Pursuit of a Bigger Pie: Can Everyone Expect a Bigger Slice?*, 8 HOFSTRA L. REV. 671, 671 n.2 (1980); Coleman, *Economics and the Law: A Critical Review of the Foundations of the Economic Approach to Law*, 94 ETHICS 649, 651-52 (1984); Posner, *Utilitarianism, Economics and Legal Theory*, 8 J. LEG. STUD. 103, 119-35 (1979).

<sup>68</sup> See Rabin, *The Revolution in Residential Landlord-Tenant Law: Causes and Consequences*, 69 CORNELL L. REV. 517, 581-82 (1984); see also Comment, *Challenging Rent Control: Strategies for Attack*, 34 UCLA L. REV. 149, 151 (1986) (outlining the argument).

dential housing.<sup>69</sup> Critics also argue that rent control is inefficient because the apartments are not allocated to those who value<sup>70</sup> them the most.<sup>71</sup>

This section first argues that the current market is not perfectly competitive, and that it therefore cannot be determined with any degree of accuracy whether Rent Control would detract from the efficient allocation of space or capital. Second, this section argues that greater empirical work is required to determine whether wealth is maximized under Rent Control. In light of the countervailing social factors favoring Rent Control,<sup>72</sup> the efficiency arguments as currently developed by critics are simply too indeterminate to serve as a compelling basis for rejecting this proposal.

Both the capital and space allocational critiques of rent control implicitly assume that the current market is the most efficient one attainable.<sup>73</sup> However, the current market is less efficient than the ideal market in a capitalist economy. Whereas the latter is characterized by perfect competition among profit maximizers directed at satisfying consumer preferences that have been developed with perfect information,<sup>74</sup> the current market is fraught with imperfections. In a market that is not perfectly competitive, the restructuring of relative prices and allocation of resources resulting from Rent Control may be more efficient than the existing distribution.

A brief overview demonstrates the imperfections of the current market. Relative prices in the current market have been influenced by decades of ad hoc government intervention motivated as much by distributional as by efficiency concerns: The federal income tax system, for example, favors homeownership over rental,<sup>75</sup> thus distorting the relative prices and allocation of resources between them.<sup>76</sup> Exclusionary zoning laws represent another governmentally imposed depar-

<sup>69</sup> See, e.g., Radin, *Residential Rent Control*, 15 PHIL. & PUB. AFF. 350, 351 (describing the argument); Weitzman, *supra* note 6, at 977-78 (same).

<sup>70</sup> Value is defined as aggregate consumer willingness to pay. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.2 (2d ed. 1977).

<sup>71</sup> Commentators argue that free markets maximize society's wealth. See, e.g., Posner, *supra* note 67, at 123. In particular, economists argue that unregulated markets serve to allocate housing best. See, e.g., B. SCHILLER, *supra* note 30, at 758-59.

<sup>72</sup> See *supra* pp. 1843-48.

<sup>73</sup> See Gilderbloom & Appelbaum, *Toward a Sociology of Rent: Are Rental Housing Markets Competitive?*, 34 SOC. PROBS. 261, 262 (1987); Olsen, *An Econometric Analysis of Rent Control*, J. POL. ECON. 1081, 1082 (assuming that uncontrolled housing markets are perfectly competitive).

<sup>74</sup> See P. SAMUELSON, *supra* note 54, at 39. For a list of the seven conditions necessary for prices to respond freely to changes in supply as posited by conventional economic theory, see Olsen, *A Competitive Theory of the Housing Market*, 59 AM. ECON. REV. 612, 613 (1969).

<sup>75</sup> See Hellmuth, *Homeowner Preferences*, in READINGS IN FEDERAL TAXATION 214 (M. McIntyre, F. Sander & D. Westfall 2d ed. 1983); *supra* p. 1838.

<sup>76</sup> See Hellmuth, *supra* note 75, at 215-16; Muth, *supra* note 17.

ture from perfect competition. Wealthy suburbs have avoided internalizing the adverse costs associated with development and poorer inhabitants<sup>77</sup> by excluding lower-income families through single-family housing, and large-lot and minimum floor area requirements.<sup>78</sup> Government-created distortions such as these make it unlikely that existing housing prices efficiently allocate housing resources.

In addition to government intervention, characteristics peculiar to the housing market are inconsistent with a perfectly competitive market.<sup>79</sup> Prospective purchasers lack perfect knowledge about fundamental yield, so they must rely for information either on real estate brokers who have an incentive to increase commissions by inflating prices,<sup>80</sup> or on current owners who may be unavailable or disinclined to provide full information.<sup>81</sup> Similarly, prospective tenants have only fragmentary information about prevailing rents.<sup>82</sup> Finally, both the sale and rental components of the housing market are composed of heterogeneous units, which make it difficult to find an exact substitute.<sup>83</sup>

Because the current market is inefficient,<sup>84</sup> one cannot conclude a priori that the relative prices and resulting allocation of resources under a Rent Control scheme are less efficient than the current price and allocation structure.<sup>85</sup> This claim applies to both space and capital.

<sup>77</sup> See *Southern Burlington County NAACP v. Township of Mt. Laurel*, 67 N.J. 151, 179, 336 A.2d 713, 727-28, cert. denied, 423 U.S. 808 (1975); A. DOWNS, *OPENING UP THE SUBURBS* 9-11 (1973); *Developments in the Law — Zoning*, 91 HARV. L. REV. 1427, 1626-27 (1978).

Some commentators have argued that any zoning, including exclusionary zoning, that allows specialization among suburbs is efficient. See, e.g., Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). There are, however, serious objections to the Tiebout hypothesis. See, e.g., Buchanan & Goetz, *Efficiency Limits of Fiscal Mobility: An Assessment of the Tiebout Model*, 1 J. PUB. ECON. 25 (1972). For a general critical evaluation of zoning's efficiency, see Ellikson, *Alternatives to Zoning: Covenants, Nuisance Rules, and Fines as Land Use Controls*, 40 U. CHI. L. REV. 681 (1973).

<sup>78</sup> See R. BABCOCK & F. BOSSELMAN, *EXCLUSIONARY ZONING: LAND USE REGULATION AND HOUSING IN THE 1970'S*, at 7-9 (1973); S. SEIDEL, *supra* note 15, at 159-86; Katz & Rosen, *supra* note 14, at 149-50; Sager, *Tight Little Islands: Exclusionary Zoning, Equal Protection, and the Indigent*, 21 STAN. L. REV. 767, 781-82 (1969).

<sup>79</sup> See generally H. AARON, *supra* note 9, at 11-22; Gilderbloom & Appelbaum, *supra* note 73.

<sup>80</sup> See *supra* p. 1840.

<sup>81</sup> Owners have an incentive to withhold information about defects in order to obtain as high a selling price as possible. See H. AARON, *supra* note 9, at 14.

<sup>82</sup> Because tenants seldom are able to gather data systematically, they often rely on newspaper advertisements that inflate rental prices. See Gilderbloom & Appelbaum, *supra* note 73, at 265.

<sup>83</sup> See *id.* at 266; Case, *supra* note 24, at 45.

<sup>84</sup> No one has ventured to test the efficiency of the real estate market rigorously, primarily because of a lack of accurate data. See K. Case & R. Shiller, *supra* note 25, at 1, 2, 15.

<sup>85</sup> This is a corollary to the theory of second best: a change (such as price controls) that

First, it is not necessarily true that Rent Control causes tenants to allocate housing space inefficiently. Although it is a basic premise of economics that a lower price increases quantity demanded,<sup>86</sup> it does not necessarily follow that Rent Control's lower rents mean people will consume more, nor does it follow that "more" is necessarily inefficient.

In both unregulated and regulated regimes, factors other than price play a major role in determining rental consumption. In the gentrifying market, high rent-to-income ratios and low vacancy rates suggest that many lower-income tenants are unable or unwilling to move into smaller apartments to compensate for higher rents; rather, these tenants adjust to increasing rent by decreasing their consumption of nonhousing goods. Under the Rent Control regime, then, such tenants will consume no additional space but will simply spend less of their income on rent and more on food, clothing, and other needs.<sup>87</sup>

Another major nonprice determinant of space consumption is the size of the household.<sup>88</sup> Nationally, average household size has declined to less than three; in metropolitan areas the average household size is often even smaller.<sup>89</sup> Because smaller households consume more space per person than larger ones, a small household will have "excess space" irrespective of whether its housing is rent-controlled.<sup>90</sup>

The importance of these nonprice factors in determining space allocation has been demonstrated empirically: living patterns under rent control simply do not differ significantly from those in noncontrolled housing. In 1981, for example, 27% of all controlled apartments in New York City underutilized space, whereas underutilization in the decontrolled stock stood at 38%. Housing under New York City's stabilization program, a moderate rent control scheme, experienced the least amount of underutilization.<sup>91</sup>

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would be inefficient in a perfectly competitive economy may enhance efficiency in a less-than-perfect economy. See generally Davis & Whinston, *Welfare Economics and the Theory of Second Best*, 32 REV. ECON. STUD. 1 (1965); Lipsey & Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956-57).

<sup>86</sup> See P. SAMUELSON, *supra* note 54, at 53-55.

<sup>87</sup> One commentator studying New York City housing in 1968 found that rent control did not increase housing consumption, but that the occupants of rent-controlled units "consumed 4.4 percent less housing service and 9.9 percent more nonhousing goods than they would have consumed in the absence of rent control." Olsen, *supra* note 73, at 1081.

<sup>88</sup> See Stegman, *The Model: Rent Control in New York City*, in THE RENT CONTROL DEBATE, *supra* note 23, at 29, 47.

<sup>89</sup> See, e.g., BOSTON REDEVELOPMENT AUTHORITY, *supra* note 3, at 9, 29 (discussing declining household size in Boston); Stegman, *supra* note 88, at 47 (discussing declining household size in New York City); *supra* note 12.

<sup>90</sup> See Stegman, *supra* note 88, at 47-48.

<sup>91</sup> See *id.* at 36, 47; Achtenberg, *supra* note 61, at 467; In Cambridge, Massachusetts, rent control has not demonstrably affected the use of space. Cf. ABT ASSOCIATES, *supra* note 47, at 43 (giving data on space utility in controlled and uncontrolled units in Cambridge).

Significantly, even if space consumption does increase under Rent Control, this allocation of resources is not necessarily less efficient. Indeed, if government intervention and intrinsic imperfections in the housing market impose costs such that the equilibrium rent is higher than in a perfectly competitive market,<sup>92</sup> by lowering economic rents the proposal, rather than causing people to waste space, may reduce overcrowding and result in a more efficient allocation of space.

Second, the allocation of capital under Rent Control is not necessarily less efficient than that existing in the current market. Rent Control maintains the existing housing market's allocational decisions because landlords cannot remove their units from the market. This allocation is not less efficient than that produced by the existing market because the current housing stock is the result of current market decisions as to the highest valued use of capital.

In the future, of course, it is possible that the current allocation of capital to housing uses may become undesirable<sup>93</sup> because of some exogenous change, such as a shift in population or income distribution. Under one scenario, a decline in housing demand or vast increase in supply could create excess housing. In this situation, capital would continue to be allocated efficiently, as long as conversions were permitted in high-vacancy areas, because Rent Control would not impose minimum rents. Under a second scenario, a change in income distribution might cause a higher value to be placed on commercial than on residential uses, even if the overall housing shortage persists. In this situation, a rigid rent control scheme would allocate capital to residential uses, whereas an uncontrolled market would allow commercial conversion. If this occurred, however, the proposed Rent Control plan could be modified to permit some shifts to commercial uses to mitigate inefficiency.<sup>94</sup> In the absence of such exogenous changes, Rent Control simply maintains the capital allocation of the current market.<sup>95</sup> Furthermore, even if Rent Control were to shift

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<sup>92</sup> Price bubbles, exclusionary zoning, lack of information, and possible monopolistic price behavior, see Gilderbloom & Appelbaum, *supra* note 73 (describing the possible existence of monopolistic price behavior); Weitzman, *supra* note 6, at 982-83 (same), all lead to prices in the current market that are higher than they would be in a competitive market. To the extent that government policies favoring condominium ownership have contributed to gentrification-induced demand, prices in gentrifying neighborhoods are higher than they would be in a perfectly competitive market. Counterforces include the tax subsidies for housing.

<sup>93</sup> The change must make housing less desirable. If housing becomes more desirable than nonresidential capital uses, Rent Control will have no effect on the allocation because it, like the market, maintains capital in housing.

<sup>94</sup> Such a change is required in current markets in most cities as well. Most cities have residential and commercial zoning, and any person seeking a shift in uses must petition a government body for a zoning exemption. See *Developments in the Law — Zoning*, *supra* note 77, at 1439-40.

<sup>95</sup> The allocation of capital to maintenance is altered under Rent Control. Whether this change is inefficient is difficult, if not impossible, to determine. In the current market, landlords

the allocation of capital, current market imperfections make it impossible to determine whether the shift would actually diminish or improve efficiency.

Critics also argue that any rent control scheme does not allocate housing to maximize social wealth because it fails to allocate housing to those most willing to pay.<sup>96</sup> This analysis is too simplistic, however. Any determination whether a Rent Control or uncontrolled housing market is more efficient can be made only by considering the dollar gains and losses to all affected groups, not just the gentrifier and the existing tenants. Rent Control confers benefits and imposes costs on an array of parties and in an array of ways not considered by traditional economic critiques. The task of determining how each party would value the benefits and burdens associated with the imposition of Rent Control generates enormous if not insurmountable difficulties.

Suppose, for example, that Community A is considering adopting Rent Control. Within the Community, landlords and those seeking to gentrify both bear some cost under Rent Control, whereas current tenants and owners of vacant land and condominiums and homes benefit.<sup>97</sup> Beyond these groups, Community A would have to consider others bearing costs and receiving benefits from Rent Control. For example, Community A would have to absorb associated administrative costs, but it would be able to spend less in the future on shelters and other programs designed to reduce the costs of displacement and homelessness.<sup>98</sup> Community A would also want to consider the effect on the tax base and community services required.<sup>99</sup> To perform an accurate cost-benefit analysis, Community A would also have to con-

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may allocate too little capital to maintenance (relative to the perfect market) because of low cash flow, *see supra* pp. 1845-46, and market failures, *see* H. AARON, *supra* note 9, at 12-13. By forcing a minimum level of upkeep, Rent Control may correct for those market failures. If, however, as critics maintain, Rent Control will result in less maintenance than that occurring under the current market, this too could be a more efficient result. *See* Niebanck, *Toward a Fuller Understanding of Rent Control*, in *THE RENT CONTROL DEBATE*, *supra* note 23, at 112 (arguing that evaluative studies must be done to determine if a housing stock that is marginally undermaintained better serves the needs of lower-income households).

<sup>96</sup> *See, e.g.*, P. SAMUELSON, *supra* note 54, at 370-73, 531-32.

<sup>97</sup> For a general overview of the costs avoided by tenants who are not displaced, *see* Durham & Sheldon, cited in note 2 above, at 25-28. Existing home and condominium owners and those who own vacant land may benefit, because the value of their uncontrolled property may increase under Rent Control. *See* Fallis & Smith, *supra* note 53; Marks, *The Effects of Partial-Coverage Rent Control on the Price and Quantity of Rental Housing*, 16 J. URB. ECON. 360-69 (1984).

<sup>98</sup> *See* Pennell v. City of San Jose, 108 S. Ct. 849, 859 n.8 (1988) (arguing that "[p]articularly during a housing shortage, the social costs of the dislocation of low income tenants can be severe").

<sup>99</sup> Gentrified property has a higher assessed value for property taxes, but its occupants usually demand more city services as well. Under Rent Control, property that would have gentrified will have a lower tax base, but the uncontrolled property will have a higher base; those two effects may or may not cancel each other out.

sider the spillover effects from its adoption of Rent Control. If Rent Control were imposed, some of the wealthy who would have purchased and converted low-income housing would move to Community B or C, raising the housing prices there to the benefit of some and detriment of others. Alternatively, Community A's lack of Rent Control may displace its poor to Communities B and C, requiring those communities to bear the costs of overcrowding and providing services for the displaced. The list of costs and benefits Community A might consider should also be expanded to include nonmonetary benefits and costs. These include, among others, the psychological distress of the displaced, the discomfort people suffer because of the plight of the homeless, and outrage at the unfairness of selecting landlords to bear the burden of Rent Control. The list also includes the loss of neighborhood cohesion that occurs when longtime members of a community move — a cost borne by both the mover and the remaining members of the community.

After Community A discerned all the affected groups and costs, it would still face the difficult task of determining what people would pay or require as payment to shift from the status quo.<sup>100</sup> Community A could not rely on the market alone to determine the efficient outcome. Transaction costs,<sup>101</sup> existing legal rules,<sup>102</sup> and costs and benefits external to market pricing prevent the market from reaching an efficient outcome. To calculate Rent Control's efficiency, then, Community A must determine what the market solution would be, if one exists. This calculus includes the decision whether to use offer or asking prices,<sup>103</sup> the determination of equivalent dollar values of nonmonetary gains and losses, and the calculation of the dollar value to a person of achieving or avoiding a result that has not yet occurred. Some commentators question whether an efficiency analysis of this type can yield a determinate result.<sup>104</sup> Whether or not this question

<sup>100</sup> See A. POLINSKY, AN INTRODUCTION TO LAW & ECONOMICS 123-26 (1983).

<sup>101</sup> Transaction costs include the cost of strategic behavior. See *id.* at 18.

<sup>102</sup> One example would be laws that prevent bargaining for votes on housing policy between residents of different towns.

<sup>103</sup> The issue as normally posed is "whether the cost-benefit analyst should measure the winners' gains by the number of dollars that they would be willing to pay (to offer) to obtain a policy's implementation or by the number of dollars that they would have to be given (that they would ask for) to acquiesce in the policy's rejection." Markovits, *Duncan's Do Nots: Cost-Benefit Analysis and the Determination of Legal Entitlements*, 36 STAN. L. REV. 1169, 1178 (1984) (offering one solution to the measurement problem). For an analysis of the differences between offer and asking price and their impact on economic analysis, see Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669, 678-95 (1979); Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387, 401-21 (1981).

<sup>104</sup> Compare Baker, *The Ideology of the Economic Analysis of Law*, 5 PHIL. & PUB. AFF. 3 (1975) and Kennedy, *supra* note 103 and Rizzo, *The Mirage of Efficiency*, 8 HOFSTRA L. REV. 641 (1980) with R. POSNER, *supra* note 70 and Markovits, *supra* note 103.

can be answered in the abstract, the overall wealth effect of Rent Control simply cannot be determined without greater empirical work.

#### IV. CONCLUSION

Gentrification in many cities has created an urban housing market characterized by rising rents and a decreasing supply of homes for poorer urban residents. The result is greater poverty, displacement, and sometimes homelessness. In this market a complete Rent Control proposal can serve as an important partial solution to the plight of the poor. By allowing tenants to remain in their units at a lower rent, Rent Control will prevent displacement and reduce shelter poverty.

Critics have attacked rent control housing policy, however, on economic grounds. Their economic efficiency arguments do not provide a compelling basis for rejecting Rent Control. Most of the economic criticisms are mistaken or are accurate only when applied to rudimentary forms of rent control or to rent control in a non-gentrifying market. In a gentrifying market, however, Rent Control will not lead to abandonment, conversion, or inadequate maintenance. Nor will it lead to a decrease in future construction. Whether Rent Control's allocation of space and capital is more or less efficient than in the non-rent-controlled market is impossible to determine, given the inefficiency of both markets. Which housing regime maximizes wealth is also indeterminate without further empirical work.

Indeed, in a gentrifying market Rent Control may increase construction of new housing, provide greater incentives to maintain rental property adequately, and ensure the continued vitality and cohesiveness of urban neighborhoods. Moreover, Rent Control will reduce the social costs associated with poverty and homelessness, including the costs of welfare programs, shelters, and medical care. In short, a regulatory pricing regime that taxes economic rents will not result in the economic harms predicted. Rather, Rent Control will increase the supply of low-income housing, reduce shelter impoverishment, and prevent the further degradation of the urban poor.