

A Dissent: The Economic Consequences of Unrestricted Rent in California

Control measures may be the lesser of evils.

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- Relative to local income, housing rents in California are much higher than the U.S. average and have been for at least the past decade.
- The reason for high rents is the combination of major restrictions on residential construction, especially for apartments, with the inability to impose new rent controls due to the Costa Hawkins Act.
- Given the serious difficulty in enacting comprehensive land zoning and property tax reform that would ease the scarcity of rental housing, repeal of Costa Hawkins and new rent controls are the only quick ways of restoring rental affordability in California.

Debate over the housing crisis in California has livened up thanks to the coming elections in November. While there have been several proposed initiatives in the past year, the most controversial is the ballot measure for the repeal of the Costa Hawkins Rental Housing Act. When passed in 1995, Costa Hawkins froze municipal rent control ordinances. It allowed existing controls to apply only to housing built in or before the year the municipal ordinance was passed, with all other housing, including any built in or after 1995, not subject to limits on rent charged.

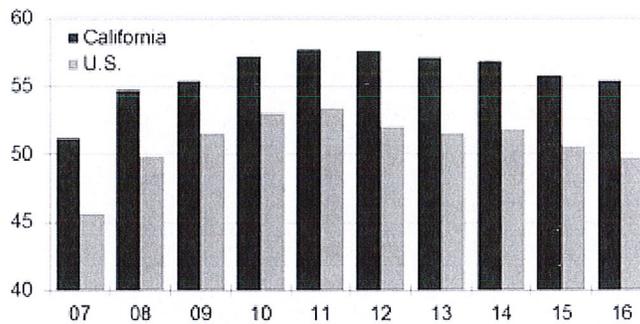
The effects of the law were gradual, but were strongly felt after only a few years. Year-over-year growth in the primary residence rent CPI for Los Angeles was practically flat in 1994 but accelerated to nearly 7% by 2001. Since then, rental affordability throughout the whole state remains a pressing problem: Affordable housing advocates are likely to get enough signatures to put a repeal of the act on the November ballot.

Old news: the rent is too high

The deteriorating affordability of rental housing in California is not up for debate; rather, it is which solution will best bring rents back within the range of normal incomes. That rent in California is too high relative to local incomes and to the U.S. has long been common knowledge. A significantly larger share of renter households over the last 10 years have been rent-burdened in the sense of paying more than 30% of their income in rents and associated utilities. This share has gone down slightly over the past five years, most likely because low affordability suppressed household formation and thus pushed up the median-income households that rent. The situation has also deteriorated since 2016 (the last year of census data): The primary residence rent CPIs for San Francisco and Los Angeles have both had much stronger year-over-year growth in 2017 and 2018 compared with the U.S. index.

Rental Costs in California Stick Out

% of renter households with rental costs >30% of income

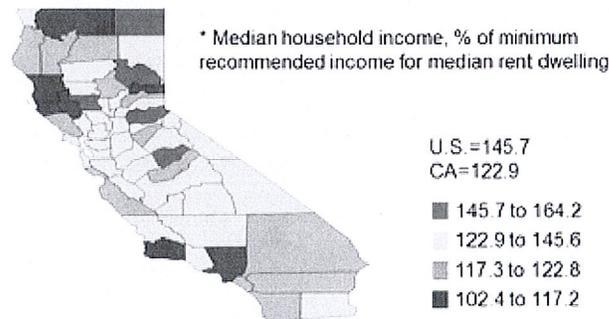


Sources: Census Bureau, Prosperity Now, Moody's Analytics

The regional distribution of this burden is lopsided. The larger potential rent burden is in the coastal areas of the state, but even here there is an imbalance: Higher median income growth in and near the San Francisco Bay Area has prevented affordability from becoming critically low at least in comparison to Southern California and especially Los Angeles County, where the ratio of median household income to median rents is probably one of the lowest of all the top 100 U.S. metro areas and divisions. In addition, the Central Valley counties in the state don't get off easily either; while their affordability is better than the California average, it still lags the U.S. average. In fact, only five rural counties in Northern California have rental affordability that is better than the U.S. average.

Southern California Is in Trouble

Rental affordability index*, 2012-2016 sample by county



Sources: Census Bureau, Moody's Analytics

The problem of below-average rental affordability, combined with low home purchase affordability, has been going on in California for decades now, and is likely a major cause of the state's low rate of household formation. There would likely be up to 1.75 million more households in California today if the state's householder rate—the ratio of households to population—had not lagged that of the U.S.

Economics 101 and rent control

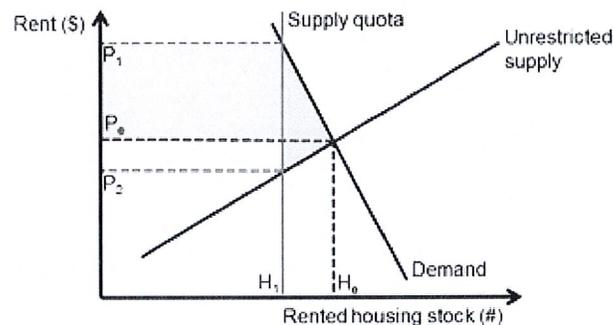
In standard economic theory, a legal rent ceiling set below the unrestricted free market rent immediately results in a drop in rented dwellings and in excess rental demand; many would-be renters cannot find dwellings even though they are willing to pay the legal ceiling rent. The restricted supply implies that not only are fewer new dwellings built than are needed, but also that some of the existing housing stock is less well-maintained, since maintenance would not be worth the more limited returns. This is why many economists oppose rent control and the repeal of the Costa Hawkins Act specifically, in favor of measures that would increase the supply of homes.

But in reality, California is not an unrestricted housing market. On the contrary, a number of state and local government policy interventions have relentlessly constrained the number of housing units that are built every year below the level of pent-up demand. These interventions include:

- At the state level, Proposition 13, passed as long ago as 1978, freezes inflation-adjusted property tax payments for current owners and thus creates a large tax subsidy for keeping homes and apartment blocks off the purchase market. This large subsidy also creates a large disincentive in many locales for new residential zoning, given that new residential properties will generate less tax revenue growth. By contrast, new commercial zoning is also subject to the property tax freeze but does generate job growth that would normally result in larger home sales turnover, boosting residential property tax revenues.
- County and city governments, especially in coastal areas, also do their best to restrict residential zoning, usually through height or story limits on apartment zoning and sometimes even bans on apartment development in selected locations. Another restriction is the requirement that new apartment structures be accompanied by full parking facilities even in urban areas with access to public transit. These restrictions are not just due to "not in my backyard" fears that apartment development would reduce local home values, but also to the plausible fear that inflows of higher-income renters would lead to the displacement of existing tenants.

The effect of all of these restrictions is that rental markets in most California urban areas are supply constrained, in effect subject to a supply quota (or more accurately, a limit on residential construction over time). The effects of a supply quota are also to reduce the number of rented dwellings, with the difference that would-be tenants are priced out of the market even though there are apartment developers who would be willing to add to the supply at lower rents but are legally unable to do so.

Rent With a Supply Quota



Source: Moody's Analytics

The supply quota shown in the above chart not only reduces the number of rented dwellings, but also leads to an efficiency loss—lost tenant savings and lost rental income—shown in the green triangle. But the loss to potential landlords is more than offset by the increased rents for existing landlords shown in the tan rectangle, which is the additional rent revenue—and therefore a loss to tenants—created by the supply scarcity.

More importantly, any rent control imposed in such a market would not lead to a drop in the supply of rented dwellings provided that the rent ceiling is close to what the rent would be in an unrestricted market; in the diagram, only a rent ceiling lower than P_2 would lead to a drop in the supply of rented homes below that of the already existing supply quota.

The political economy of residential zoning and rent control

Economic theory thus has a straightforward answer to the problem of rental scarcity and too-high rents in California. The first-best solution is to eliminate the state and local restrictions that reduce the amount of residential construction, especially restrictions on apartment zoning. By comparison, rent control is a second-best solution since it only redistributes income towards tenants without actually increasing the quantity of rented dwellings. If political considerations were not an issue, economists would unhesitatingly prefer to remove restrictions on residential construction rather than impose rent controls.

The problem is that for at least a decade, initiatives to increase residential construction have failed to pass legislative or enforcement hurdles. Previous state requirements for county and city governments to plan minimum amounts of residential zoning often lead to zoned tracts in the planning stages but with little, if any, actual construction. The anti-construction inertia inherent in the state's coastal counties is symbolized by the April defeat of SB 827 in the California legislature. SB 827 was a bill that would have required city and county governments to allow construction of five-story apartment buildings in urban areas near train stations, light rail stations, and high-frequency bus stops. SB 827 was opposed not just by homeowners, but also by renter advocates who were plausibly worried that too many poorer tenants would be displaced as their homes were bought up and demolished to make way for new apartments.

The opposition to new construction is by no means a simple case of homeowners and apartment owners banding together to protect their extra income derived from supply scarcity. On the contrary, the California Apartment Association, among other organizations, supported SB 827 and have in the past supported other attempts to loosen residential zoning restrictions. Owners of single-family homes, including not just individual families but also rental companies such as Invitation Homes, are also not averse to expanding the single-family housing stock.

The problem is that each group is implacably opposed to rent control but also does not want the other group to benefit from looser zoning at their expense: Homeowners generally oppose apartment construction in their neighborhoods while apartment developers know that increased sprawl of single-family neighborhoods is also not in their best interests. And neither group wants to give up the implicit existing property tax subsidy. So neither broad group has so far been willing to get behind any residential zoning reform that is broader and more comprehensive than what was proposed in SB 827. On the other side, tenant advocacy groups understandably oppose any zoning reforms that would increase gentrification in the short term even if such reform increased the supply of for-rent dwellings in the long term.

Broader reform

One step in the direction of broader zoning reform has been the push to repeal the Proposition 13 provisions for commercial properties, which would end the bias in favor of commercial as opposed to residential or mixed-use zoning, and which has helped to generate local job growth without residential construction to match. Here also, opposition to this push is strong, and it is highly unlikely to make it onto the November ballot.

In addition, truly comprehensive zoning reform would not only act to drive down both home values and rents in order to restore affordability across the board, but would also comprehensively address both gentrification and overcrowding concerns. A complete reform of residential zoning would have to include provisions to minimize tenant displacement such as inclusive zoning provisions that would require and even subsidize developers to build homes and apartments affordable to low-income tenants. Also, comprehensive reform would have to address the justified fear of increasing economic and population density in coastal areas. Much of the opposition to increased apartment zoning in urban areas such as San Francisco is driven by the laudable goal of preventing California cities from attaining Manhattan-like building and population densities.

But suppressing residential construction has not been a good method of achieving this goal and has led directly to the affordability crisis. A better broad answer is for the state to displace commercial development and job growth. Too much job growth in the state over the past decades has taken place in the Bay Area and Greater Los Angeles at the expense of the Central Valley and Riverside, leading to the trend of the inland counties becoming bedroom

communities orbiting around the economic dynamism of the coast. The best answer is to allow coastal California counties to set much higher commercial property taxes that can be raised as needed. Here again, a substantial scaling back of Proposition 13 restrictions would be needed.

The lesser evil

Given all of these requirements and the fractious nature of legislative politics in Sacramento, such a comprehensive reform of residential zoning and property taxation is years if not decades away, which leaves California between a rock and a hard place for the present. In the absence of either zoning reform or rent control, rental housing will remain unaffordable for too many of the state's residents, leading to suppressed household formation, out-migration, and reduced business investment despite the implicit property tax subsidy. Or perhaps enough California voters may vote to repeal Costa Hawkins in November, restoring the ability of local governments to enact rent control. Another legislated restriction on housing markets is not an outcome that would please any economist, but given its greater likelihood and its expediency relative to the political difficulties of comprehensive zoning reform, rent control is by far the lesser of two evils.

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