

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And /
Or Sponsoring Organization Is Missing

5. Market Analysis/Urban Economics/Real Estate
Process

h. "Outline of Observations on Rent Control
in General and as an Ordinance for
Madison in Particular", no date

Outline of Observations on Rent Control in General
and as an Ordinance for Madison in Particular

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- I. It has been proposed by Alderman Davis and others that Madison consider instituting a five person commission appointed by the mayor to review and approve all rent increases prior to their being made operational by the landlord. Legitimate costs are to be passed through to the tenant along with some "fair rate of return" to the owner. Such a serious legislative step raises three basic issues about rent control:
 - A. What aspects of housing costs and the rental equation can the public really control?
 - B. What is the cost-benefit relationship of rent control as an instrument of city policy?
 - C. If the cost-benefit ratio is marginal or negative, what are the possibilities of realizing city housing policy goals by other methods?
- II. Rental property investment is a cash cycle business which first requires cash solvency after payment of interest and principal and then cash returns on equity position of the investor. There are at least two classes of investors in a rental project, the mortgage lender and the equity owner.
 - A. Presently in Madison cash operating costs take 25-35% of cash rents received depending on age, tenant mix, and style of building. These include some utilities, maintenance, insurance, accounting and management services and so on. Most of these costs are set by agencies and labor markets beyond the control of the landlord although some reflect the degree of service and quality of maintenance provided at the discretion of the landlord. Real estate taxes take another 18-25% of cash rents.
 - B. Net cash income for multi-family investments represents between 10-12% of the total cost of the project before interest and principal payment, income taxes or return on the equity investment. Since the debt service constant for interest and principal varies between 8.5% and 11% of original mortgage balance as determined by the money market, the spread left to the equity investor is 1-5% of rental cash value depending on his vacancy rate and his mortgage term. In recent years the newer projects have shown negative cash returns due to exceptionally high interest costs and over-building for some market segments.
 - C. Institutions prefer reliable cash flow and therefore invest in multi-family mortgages; equity investors find cash returns are inadequate unless income tax shelters are available in the short run and inflation hedges are available in the long run. Small investors do not understand present value of money concepts and large sophisticated investors do not invest equity cash in multi-family housing.

- D. Now what would the public commission control? Insurance? Labor costs? Utilities? Interest rates? Maintenance repairs?
- E. The real estate tax - the largest single item in Wisconsin rents is already within political control and the politician has been notably reluctant to improve the equity of this tax by increasing administrative budgets for its collection, amendment of statutes which are obsolete in setting assessments, or reducing the costs of government which determine the mill rate.
- F. Therefore, it would appear that those seeking rent controls wish to score on the popular issue of "get the landlord" and perhaps achieve a temporary reduction of rents of 1-5%. To protest the objective is otherwise, denies the implication of the Madison proposals which would pass through all cost increases to the tenant with the possible exception of cash returns for landlord management and capital.
1. Everyone can see some cash incentive is needed to attract mortgage and equity capital and property management expertise. The more astute also can see that the relatively unattractive returns to multi-family housing capital relative to alternative forms of investment have required higher interest rates, government subsidy of the supply of mortgage funds, and indirect subsidy by means of the tax law over the last decade.
 2. If the rent control commission were to succeed in eliminating any increase in cash for the investor, it will also succeed in eliminating any inflationary increase in sales price which is always a function of earnings for income property investment. Thus it would eliminate the inflationary hedge which real estate investment represents both to the small property investor and the fat-cat landlord.
 3. To avoid that trap, how does the commission define the exact value of the equity capital position to provide a fair return? Is it original cash invested, say in 1955, or liquidated value, or the present value of all future net returns? In that case, what is a return on undefined equity? Cash income, mortgage amortization, tax savings to other income? What is the formula for a "fair rate" which has gone undefined since Aristotle?
 4. Therefore profit control through rent control implies that local city hall politicians know how to measure what is needed for incentive with such skill that they can guarantee the residents of the city that private capital will continue to invest in rental housing to maintain, modernize, or increase the supply of rental housing which serves more than 60,000 Madison residents and represents 25% of the total tax base. That is quite a guarantee!
- III. The usefulness of rent control as an instrument of municipal housing policy may create a specious reduction or stabilization of rents in the short run but the long term costs of such a benefit are easily predicted from the history of rent control.

- A. Rent control is a form of rationing of a scarce resource. Since supply is fixed, a reduction in the price for some must raise the cost for somebody else or reduce the quality of the product for everyone.
- B. If revenues are fixed so as to squeeze out the cash returns to the landlord, the landlord must conserve his cash profit by reducing outlays within his discretion.
 - 1. Like the railroads with fixed tariff rates, the landlords could simply undermaintain their property until rent controls were removed or the majority of properties were blighted.
 - 2. Since modernization and new construction would be sharply reduced, the owners of desirable properties in the city could reduce turnover and vacancy costs and collection losses by becoming more selective of tenants and increasing collections of damage deposits, registration fees, or under the table bribes. It is not unlike fixing the price of all auto liability insurance, until underwriters refuse to accept the marginal auto driver.
 - 3. Presently some management charges a premium rent and reduces the cost of vacancy and turnover by providing extra super maintenance and service. They could survive for a time by just gradually reducing services.
- C. Over a period of 3-5 years financial services with a vested interest in the condition of the real estate could change the price of their services which would be passed through as a cost to the tenant:
 - 1. The preferred risk insurance company which provides the property and fire coverages at the lowest rates would withdraw from the Madison market or go back to full manual rates as the condition of the properties deteriorated.
 - 2. Mortgage lenders make loans in such a way that the total cash charges of expenses, real estate taxes, interest and principal do not exceed a certain percentage of gross rents called the default point. As expenses became a greater percentage of the total permitted rent, the lender would reduce the number of dollars of interest and principal payments permitted as an obligation of the borrower, by reducing the loan available for the property.
 - 3. Reduce the availability for credit and increase the cash equity required for investors and investor demand for properties would fall sharply and market values would sag.
 - 4. The City itself depends on the market value of its private real estate for its tax base and as prices for rental property fell, the owner would have cause to reduce the assessment. It is estimated that multi-family rental housing represents 20-30% of the Madison tax base.

- D. If values of multi-family housing were stabilized or declined during a period of inflationary price rises to other forms of real estate, the tax revenue burden would gradually shift to the other forms of real estate, primarily the single family homeowner for which assessment practices maintain the most current market value assessments.
- E. Clearly the cost of rent control fall both on the tenant as he receives less and less housing quality for a dollar and on the single family homeowner, the two largest groups of taxpayers within the city borders.
- F. Recent experience with new rent controls have shown an immediate and significant reduction in permits to construct new or remodel existing housing. A corresponding increase has been detected outside the political borders of rent control. The advocates of rent control indirectly acknowledge this in the Madison ordinance by proposing to exempt new construction.
1. Why would new investment money venture into an area where rent controls already existed and the politics in the area had already demonstrated a willingness to roll back rents or roll forward controls on an arbitrary basis?
 2. The date for inclusion of properties under rent control is subject to legislative whim but more serious to private capital investment incentive is found in the statements of those who advocate rent control on the basis that the system of private investment has failed and that forced abandonment over the long term is a means of uncompensated expropriation. That type of political climate is chilling to all forms of private investment in a given community over time.
 3. Local investors in multi-family would seek locations well beyond Madison annexation powers, thus increasing pressure for urban sprawl in addition to being counter-productive relative to improving densities and urban quality in metropolitan centers.
- G. The Madison ordinance would apparently place the costs of appeal on the tenant and the cost of raising of rents on the landlord. How much would the city have to pay a five member panel with sufficient expertise to provide the most equitable administration of this non-economic legislation? During a period of rising inflation 5,000 landlords could file increases each year and with 50 working weeks of 5 days each, the panel would have to study carefully audited financial statements at a rate of 20 properties a day! Is the cost of auditing passed through to the tenant? Is the cost of the landlord's appeal passed through to the tenants of a particular landlord? Is the cost of defending a tenant complaint passed through when it proves to be without grounds? One tenant in a 24-unit building could easily cost the other 23 tenants \$20 apiece!

- H. To achieve a nominal reduction of 1-5% in cash rents per tenant, not only would the tenant pay for the cost of administering a cumbersome and historically unworkable control system but the City would pay with a reduction in property tax collections from multi-family housing, a loss in housing starts to neighboring market areas, and with immeasurable damage to the visual appearance to housing and the internal environmental quality of living units. What benefits are of so certain amount that the City dare incur the risk of such high costs?
- I. The possibilities of even measuring the benefits or usefulness of rent control are made unlikely when the advocates of rent control have not stated who they are trying to help or which scarce commodity they are attempting to ration with non price systems.
1. Which community segment needs priority assistance? The long term Madison resident with modest income? The temporary Madison resident-student who has every expectation of middle class income after graduation from college? The elderly?
 2. There is no such thing as one housing market. It consists of many micro-markets defined by location, family type, size of living area required, and features desired.
 3. Those who advocate rent control are proposing a solution to a question which has not even been stated correctly.
- J. Disregarding classical economic theory for the unfortunate history of rent control which current advocates in Madison dismiss as irrelevant, government experience with housing has shown that the effective economic policies which have helped low income groups acquire housing are those which have subsidized an increase in the competitive supply or those which have increased the effective buying power of low income families.
1. All parties concede that rent controls discourage new supplies.
 2. At the same time the costs of administration will be passed through to the tenant so that any reduction in the rate of increase in rents will largely be offset by the cost of administration.
 3. In what way, therefore, does rent control provide a cure to the shortage rather than a politically convenient aspirin for the symptom?
- IV. If the objective of rent control were more clearly defined, it would presumably result in some consensus to the effect that the supplies of acceptable housing units at a price within the means of certain low income housing segments be increased at certain preferred locations.
- A. People are more mobile and fickle than real estate so many supplies of housing in Madison are in the wrong place (like dormitories on campus or new apartments south of the beltline).

Some supplies are run by the wrong people, (either the University where the price is right or by out-of-town owners where the price is too high or by grouchy landlords where the services aren't provided). Then again there are efficiencies in excess supply downtown in the wrong price range and preferred older structures with multiple bedrooms and low rents are torn down in favor of other land uses and so on. The problem of supply of the desired unit at the right place at the right price is far more complex than can be corrected by profit expropriation.

- B. For purposes of discussion assume that the objective of a City of Madison housing policy is:
1. To increase the supply of housing for the long term chronically low income residents in areas with required jobs and services.
 2. To increase the supply of choices within the various price ranges affordable by the elderly.
 3. To increase the supply of housing alternatives for students with limited means.
 4. To increase the supply of housing alternatives for the handicapped with limited buying power.
- C. In defining supply, the number one priority would be location, the second priority would be quality, and the third priority would be size of living unit or square feet per person. (Smaller cars cost less, use less gas, and pollute less. Smaller living units cost less for the tenant and the public too).
- D. With a more directed statement of the problem, the possibilities come to light of realizing the goals of housing policy by other methods of proven benefit and less direct or indirect cost of unknown magnitude or ramifications within a free market system. For example:
1. The City of Madison could begin by achieving significant reform of the city and county real estate tax assessment program which is the largest single cost item in housing which is within the control of government.
 2. The City could subsidize housing in critical locations by purchasing land and leasing it to selected non-profit entities for \$1 for 40 years, waiving a real estate tax on the land thereby and charging a real estate tax only on the improvements.
 3. The City could provide more aggressive low interest loan programs for the remodeling of older structures to improve quality without full costing of the capital required.
 4. Lobby for the payment of fees in lieu of taxes by all government entities and tax exempt charities on the land held by these entities to avoid the administrative problems of appraising the improvements and to encourage the University and others to release surplus land in various parts of the city for student or low income housing.

5. The City could down-zone surplus commercial lands and provide incentives for conversion of these lands for housing purposes as on East Washington, Atwood, or Monroe Streets.
 6. The City might reduce the number of students in its existing subsidized housing units in Madison while at the same time the University could place income qualifications on eligibility for Eagle Heights so that truly low income student families could be accommodated and city spaces released for longer term chronically poor residents.
 7. The University of Wisconsin could convert some of its lakeside dormitory-offices back to small apartments for married students by adding prefabricated utility towers with kitchenettes and baths at the perimeter of these low rise buildings.
 8. The City could institute a building permit program which would provide more accurate data as to the size and type of new housing produced and remodeled and require a six month inventory of vacancies by location and price range from all landlords in the city to correctly identify on a current basis the shortages and oversupply of residential space since many mistakes of private capital are a result of misinformation or only partial information of the market. By the same token knowledge of vacancies would assist social agencies assisting low income families.
 9. Take advantage of free market mistakes by acquiring through eminent domain gas station sites which have little current market values but some residential utility or apartment projects of recent construction which are in foreclosure and might be acquired for less than the cost to construct.
- E. Virtually all of the above recommendations take advantage of the law of supply and demand and make the price system in the free market work to the advantage of the low income housing sector. Such a process is cheaper and quicker than this doubtful process of socializing one small area of the economy with untold disequilibrium to the balance of the City of Madison economy.

Rent control bill gets mixed reaction

By TOM BURTON
of the Herald Staff

The rent control ordinance which will be introduced to the Madison City Council Tuesday will probably meet stiff opposition from landlords.

"We're opposed to rent control. It stifles investment incentive, and will result in less available housing," said Bill Smith, executive director of the Madison Apartment Owners Association.

"Rent control when it has been implemented hasn't worked," Smith said. "It will not only hurt building, but will also retard rehabilitation of existing housing."

City Ready for Controls

But Ald. Ray Davis, Eighth Dist., said he "thinks the city is ready for it." He is one of four alderpersons co-sponsoring the ordinance.

It would create a five-member rent control board appointed by the mayor with the power to make rent adjustments. A landlord would have to apply to the board for a rent increase and be able to justify it at a public hearing. Tenants would have the same power to seek decreases in rent.

UW Residence Halls and owner-occupied houses with less than three rental units or six people would be exempt from the ordinance.

"This ordinance is designed and intended to exert a measure of public control over the rental rates now charged for residential housing in Madison," said Davis.

UW business Prof. James Graaskamp agreed with Smith that rent control would lead to deterioration because it would discourage investment.

"Rent control has always failed, and always will fail. The very people it is designed to help will be destroyed," Grasskamp said.

Davis countered the view that control would lead to decay, since "Rehabilitation of existing housing is a valid reason for landlords to seek rent increases."

New construction would not be influenced by the rent control. The ordinance would exempt all apartments built after its adoption, Davis said.

Tenants May be Charged

Davis noted that costs of the proposed board would be defrayed by a yearly registration

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—UW Prof. James Graaskamp

fee to be passed on to the tenants, but that such a fee—about \$3 a year—would not be significant as an increase in rents.

"As a practical man, I can't say rents will go down," said Davis, "but the ordinance will slow down the rate of increase in Madison."

There may be a problem with the constitutionality of the bill, because an opinion by the state attorney general's office said an assembly bill (AB 95) dealing with rent control was "deemed incomplete and constitutionally infirm."

"Probably the only acceptable justification for broad rent control legislation has been a bona

fide emergency," the opinion said.

Davis answered, "It's questionable if it needs to be an emergency. A previous attorney general has held that rent control can be instituted without an emergency."

Davis said there was a "really good chance" of passing the ordinance, but that it definitely will be a close vote.