Rent Stabilization Board

Rent Stabilization and the Berkeley Rental Housing Market 15 Years after Vacancy Decontrol

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Jay Kelekian, Executive Director

Stephen Barton, Ph.D., Deputy Director

2125 Milvia Street, Berkeley, CA 94704
Tel: (510) 981-RENT TDD: (510) 981-6903 FAX: (510) 981-4910
E-mail: rent@ci.berkeley.ca.us Internet: www.ci.berkeley.ca.us/rent

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Summary

The Berkeley housing market is a small part of a much larger and very dysfunctional San Francisco Bay Area housing market characterized by a severe shortage of affordable housing. Over the past thirty years the Bay Area market has consistently failed to produce enough new housing to stabilize rents at levels that are normal in most other American cities. As a result, Bay Area tenants are at a competitive disadvantage, their rents increase faster than the overall rate of inflation and Bay Area rents, including Berkeley's, are among the highest in the U.S.

Since 1980 Berkeley has tried to protect its tenants from unnecessary rent increases by regulating rents, but beginning in 1999 the State of California required Berkeley to allow "vacancy decontrol", meaning that when tenants move out the landlord sets the initial rent for the new tenants without restrictions and only future increases on the same tenant are regulated.

The Berkeley Rent Board has recently conducted several studies that examine the effects of vacancy decontrol in Berkeley. Today the average decontrolled rent is up by over 50% after adjusting for inflation. Berkeley tenants now pay an additional $100 million annually in rent over and above the increases needed to provide owners with a fair return on their investment but only 10% of the increased rent is being reinvested in the community through building renovations and increased tax payments. The value of Berkeley's 19,000 rent stabilized apartments has doubled, increasing by from $1.2 to $1.5 billion, yet two thousand apartments remain unsafe in the event of an earthquake and several thousand more have persistent maintenance problems.

The Rent Stabilization and Eviction for Good Cause Ordinance continues to provide stability and security to tenants after they move in by controlling future increases but its economic effects are limited. It remains a major public policy challenge to find measures that will protect low-income tenants and generate a greater degree of reinvestment in rental housing and in the community as a whole.

I. The Bay Area Affordable Housing Shortage

"Rents are pushing against the ceiling of incomes. High rents are already causing the familiar tenant outmigration from San Francisco to Alameda County and its not unrealistic to expect the flow of renters seeking lower living costs to move from Alameda County inland." The Registry, January 20, 2013.

"Rental Sticker Shock -- Apartment rents in the Bay Area's three biggest cities continue to rise, with Oakland seeing a huge surge." San Francisco Chronicle, October 19, 2012.

"Now is absolutely the best time to invest in residential income property. … Rental rates have increased dramatically over the last year as tenants compete for scarce rental offerings." San Francisco Chronicle, October 12, 2012.

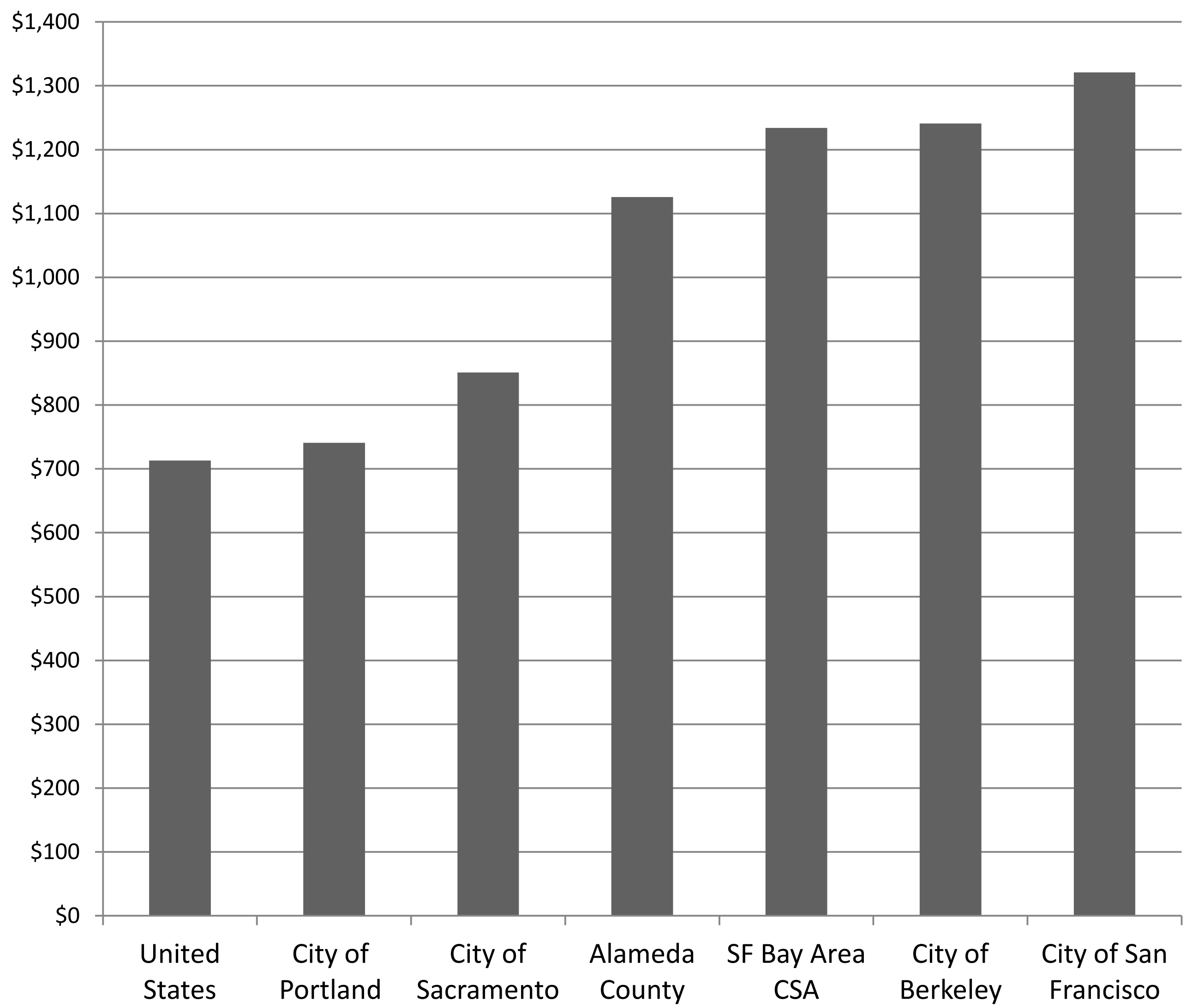
The headlines come and go from year to year as one economic cycle follows another, but despite periodic ups and downs the overall trend has been clear since the late 1970s. Real (inflation-adjusted) rents continue to increase and tenants pay a higher and higher proportion of their incomes for rent. The San Francisco Bay Area housing market has been dysfunctional for a generation now, with home prices and apartment rents that are among the highest in the United States and extreme shortages of housing affordable to low-income people. The result is that the 44% of Bay Area households who rent are at a severe competitive disadvantage while the market delivers high rents and profits to investors.

Berkeley's rental housing market is a small part of the larger Bay Area housing market and cannot be understood outside of that context. The Census Bureau estimates that Berkeley had 28,390 units of housing that were rented or available for rent in 2010 out of nearly 400,000 rental units in the East Bay (Alameda and Contra Costa Counties) and 1.2 million rental units in the San Francisco Bay Area. The majority of employed Berkeley residents commute to other cities to work and the majority of people working in Berkeley live in other Bay Area cities. Embedded in this larger market, Berkeley's rental housing follows much the same pattern as other centrally located Bay Area cities.

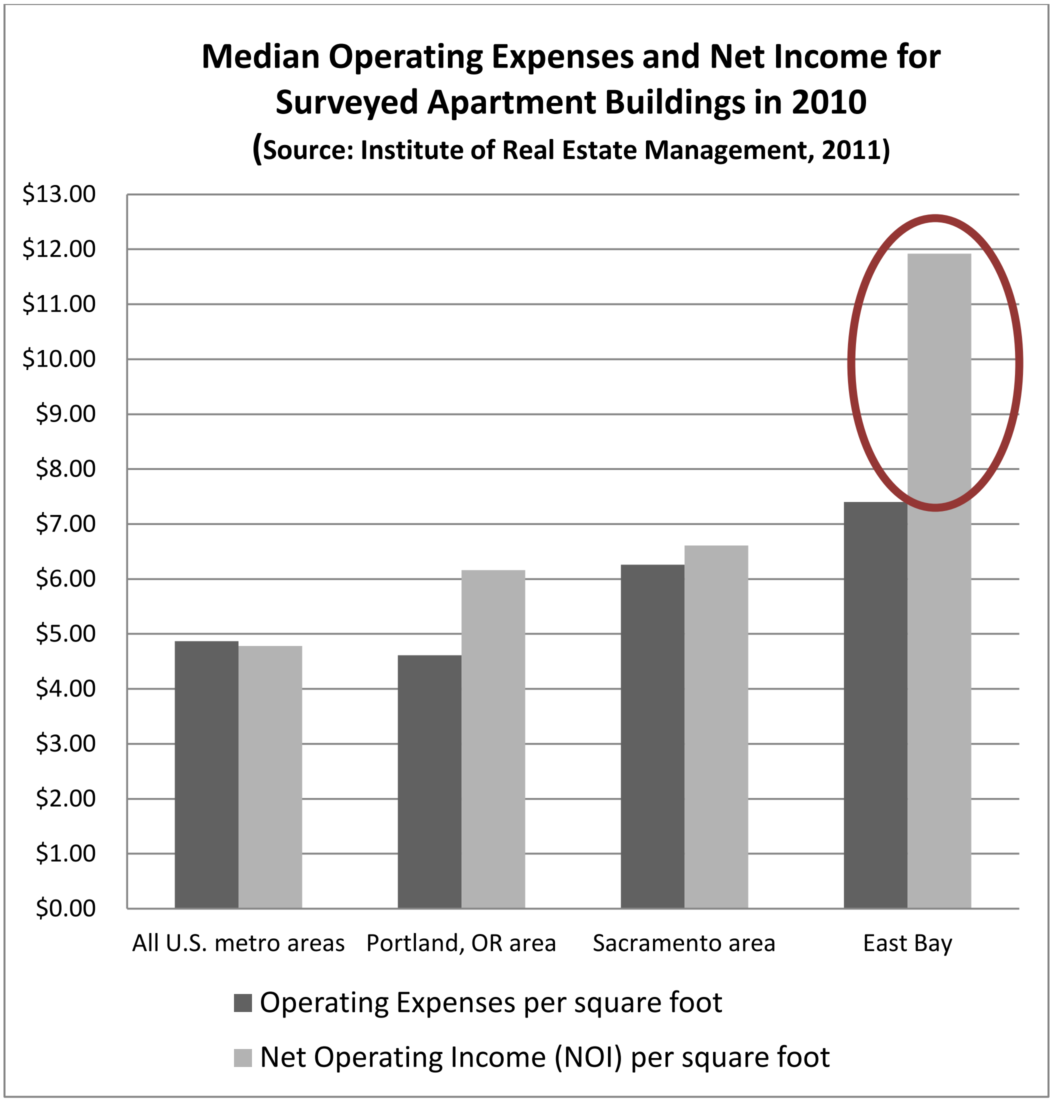
Figure 1, "2010 Median Rents", compares rents in Berkeley and the Bay Area with other cities and the U.S. as a whole. Berkeley's rents are typical for the Bay Area, somewhat higher than the average for Alameda County overall and slightly lower than San Francisco. These rents are substantially higher than the average rent in the United States or for Portland, Oregon. Portland is widely regarded as one of America's most livable cities, but has much better balance between supply and demand.

Figure 1: 2010 Median Rents

Source: Bureau of the Census



The higher Bay Area rents cannot be explained by higher costs to operate and maintain residential rental housing in the San Francisco Bay Area. Figure 2, "Median Income and Expenses for Apartment Buildings in 2010", uses data from an annual survey conducted by the Institute of Real Estate Management, an affiliate of the National Association of Realtors. This survey allows us to compare the variation in operating expenses and net operating income between different areas.



Operating expenses are the cost of normal operations, including management, taxes and insurance, maintenance and other recurring costs. **Net Operating Income (NOI)** is the revenue available to the investors after paying the normal operating expenses, so it is the best and most widely used measure of the profitability of the property. NOI is not entirely profit, however. New construction costs are typically repaid from NOI over the first twenty years of occupancy and over time, as it becomes necessary or desirable to carry out renovations and upgrades that go beyond normal maintenance, these are also paid for out of the NOI.

Figure 2 compares operating expenses and NOI for the East Bay (Oakland Metropolitan Area) with the U.S. as a whole, with the Portland, Oregon area and the Sacramento area. As shown in Figure 2, most of the higher rent characteristic of the East Bay goes to increased net operating income and not to operating and maintenance expenses. East Bay rental properties generate much more income for investors than similar properties in most other areas of the U.S. Investors in rental property in the Portland and Sacramento areas deliver rental housing that is at least equal in quality to that in the Bay Area at far lower rents.

The Bay Area's affordable housing shortage is the result of high demand and limited supply. The high demand for housing in Berkeley and the Bay Area is generated by:

- beauty of the natural setting
- diversity and creative culture of the people
- strong regional economy (anchored in Berkeley by the University of California)
- high quality public services (City, School District, County, parks districts, BART, etc.)

The residents of the Bay Area, homeowners and renters alike, contribute to making the Bay Area a desirable place to live through their taxes and their daily activities. Homeowners benefit when their positive contributions help raise property values, but tenants positive contributions raise the value of property owned by investors and have the perverse result that the tenants must pay more to rent or to buy a home.

High demand does not create long-term scarcity unless there are also constraints on supply. In a fully competitive rental housing market, increases in rents due to increased demand for apartments would soon lead to increases in supply that would then stabilize rents and bring them back down to the minimum level necessary to operate and maintain the housing. Instead, for the past 35 years Bay Area rents have risen faster than the rate of inflation due to severe constraints on apartment development that prevent addition of sufficient housing to stabilize the market and keep rents from rising.

There is extensive debate over their relative importance, but the major constraints are:

- The geographical constraints on construction in a region where much of the area near employment centers is taken up by the Bay and the ocean or is on steep hillsides.

- The cost constraints of redeveloping already urbanized land, where demolition of existing buildings, building to greater heights and construction on small sites all add to costs.

- Land use regulations often prefer lower density development and single-family homes over apartment buildings. In most cities the majority of voters are homeowners who generally oppose higher densities in or near their own neighborhoods.

Regardless of which factors are more important, tenants are not responsible for creating the shortage of rental housing but they are made to pay the price. Scarcity generates rents far higher than what is normal for the U.S., far higher than what is normally needed to profitably operate and maintain rental housing and far higher than would characterize a properly functioning housing market. As we see in Figure 2, East Bay rents are far higher than rents in reasonably competitive markets such as Portland, Oregon or Sacramento, and most of this difference goes into net operating income. This results in a major transfer of income from tenants to real estate investors.

Standard economic theory tells us that in a fully competitive market, competition between suppliers will reduce the price of housing to the minimum necessary to profitably operate and maintain rental housing. Figures 1 and 2 demonstrate that the Bay Area rental housing market is generating rents far above what is necessary. This distinction between the necessary and unnecessary rent dates back to Adam Smith, whose book *The Wealth of Nations*, published in 1776, is generally considered the founding statement of market economics. Smith distinguished between the “building rent” and the “ground rent”. <u>Building rent</u> is the amount that would be paid in a fully competitive market and is necessary to operate and maintain rental housing and provide a normal rate of return on investment to its owners. <u>Ground rent</u> is the additional rent paid because there is a scarcity of housing available in a desired location. Smith further argued that the ground rent reflects the value of the services and protection provided by government and should be taxed to support those services. “Ground rent”, “land rent”, “locational rent” and other similar terms are all forms of what economists today call “economic rent”.

Economists use the technical term <u>economic rent</u> to describe excess business revenue that is above and beyond what is actually necessary to induce production of goods and services within a fully competitive market. Another way of characterizing economic rent is that it is business income that is “unearned” in the sense that it results from simple ownership of a scarce good rather than from activities that produce goods and services or improve their quality.

II. Effects of the Housing Crisis on Tenants

The result of the Bay Area's increasingly dysfunctional market is that today Bay Area tenants as a group are economically worse off than tenants were thirty years ago.

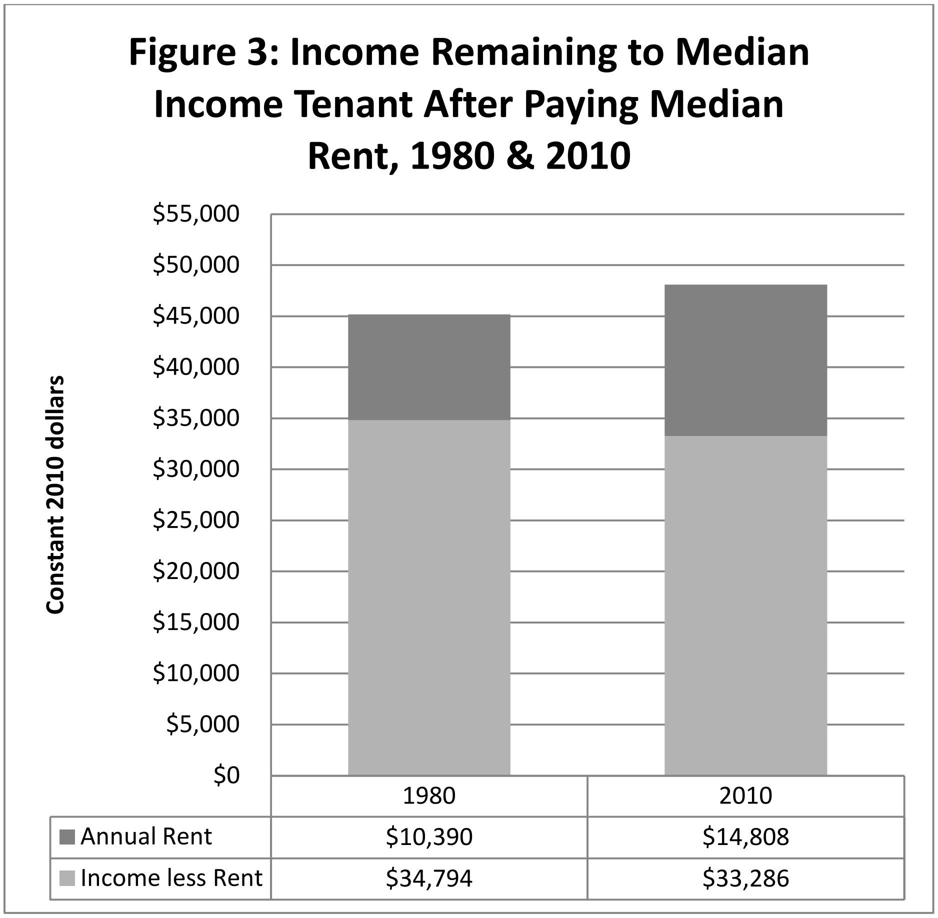


Figure 3: "Income Remaining to a Median-Income Bay Area Tenant After Paying the Median Rent" is based on data from the Census Bureau and the Bureau of Labor Statistics. It shows that after adjusting for inflation the median income of a Bay Area renter had increased by 6%, while the median "real" (inflation-adjusted) rent had increased by 43%. As a result, the median income tenant has 4% less real income remaining after paying the median rent in 2010 than the median income tenant in 1980. Even though the median renters' income had gone up from 1980 to 2010, rents had increased by so much that they took all the increase in income and more.

Figure 4 shows that the situation of a low-income renter with an income at the 25th percentile was far worse in 2010 than for the equivalent tenant in 1980. Not only had their real income declined by 17%, but they paid 34% more for a low-end apartment with a rent at the 25th percentile. As a result, the low-income tenant had 40% less income remaining after paying the rent for a low-rent apartment than the equivalent low-income tenant in 1980. The 2010 low-end 25th percentile rent of $916 monthly in the Bay Area is $203 higher than the median rent for all United States metropolitan areas, yet the lower-rent Bay Area apartments are often in poor condition because the tenants at the low end of the market have little bargaining power.

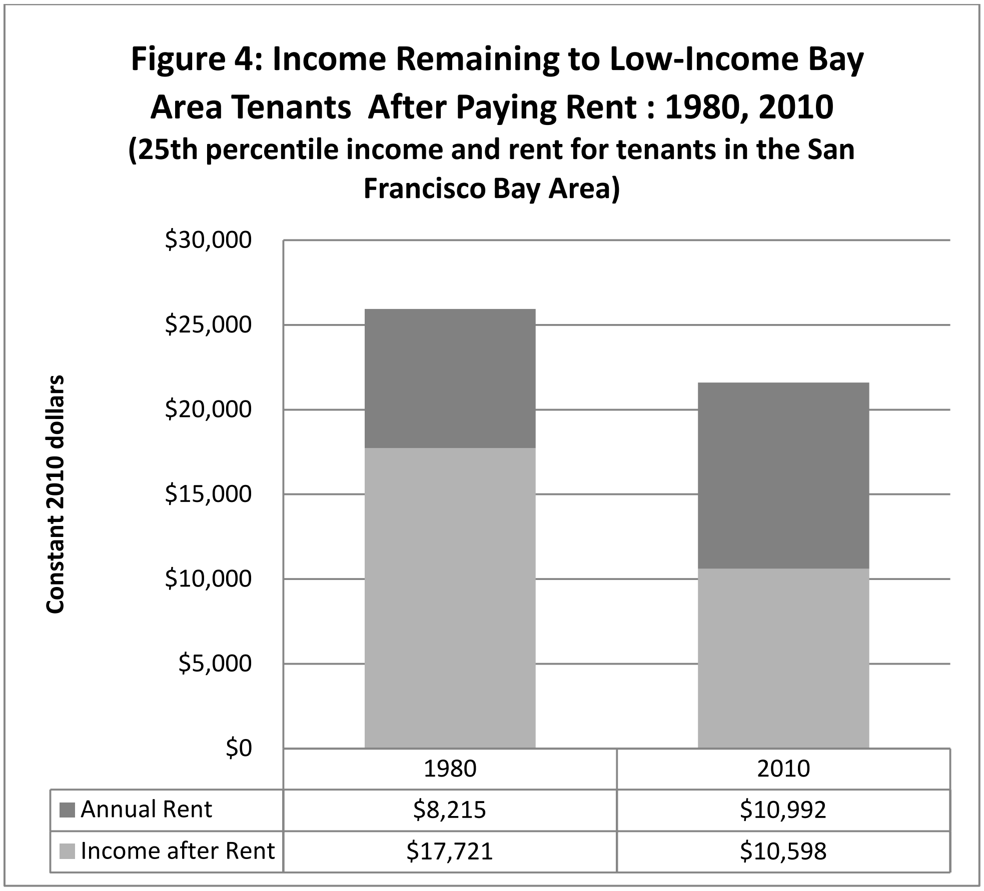


Figure 4: Income Remaining to Low-Income Bay Area Tenants After Paying Rent : 1980, 2010
(25th percentile income and rent for tenants in the San Francisco Bay Area)

For thirty-five years rents in the Bay Area have increased faster than the rate of inflation but this has not generated sufficient additional supply to stabilize rents. It is clear that the Bay Area's housing market is dysfunctional and that remedies are needed that go beyond simple appeals to let the market work its magic.

III. Understanding Net Operating Income and Profit

The dysfunctional Bay Area rental housing market generates rents and net operating incomes far higher than what is normally needed to profitably operate and maintain rental housing, as we saw in Figure 1 and Figure 2. However, even when a rental property is generating a high Net Operating Income (NOI) this does not guarantee that the landlord is the one making a profit on this investment. If the landlord fully owns the property and has not borrowed against it, then they are the sole investor and receive the full NOI. Most landlords borrow a significant part of the purchase price, forming a partnership with a lender.

The lender receives a steady income and repayment of the loan at relatively low risk while the owner receives the remaining cash flow and the chance to make a much higher rate of profit. The landlord pays the operating and maintenance expenses and from the net operating income they then pay any investment expenses, which include the mortgage and the expense of building renovations that go beyond normal maintenance (often this is handled by refinancing or taking on an additional mortgage) and, once the operating and investment expenses are paid they receive:

- The cash flow, which is the remainder of the NOI.
- The tax benefits of the depreciation allowance.
- Increased equity in the property as the mortgage is paid off.
- The capital gain from any increase in the value of the property.

It is always possible for a buyer to pay so much for a property that once the buyer becomes the current owner they make little or nothing on their investment. While lenders typically limit loans to amounts that leave a modest positive cash flow for the owner, it is not uncommon for landlords to purchase property with loan amounts that result in no cash flow or even a negative cash flow in the early years of ownership, often because the buyer underestimated the cost of maintenance and necessary repairs. A 2009 survey of landlords in Los Angeles found that a substantial proportion of those who purchased the property after 2000 were now delaying major maintenance, likely due to high mortgage payments. Buyers of investments such as rental property are vulnerable to what economists call “the winner’s curse”, the tendency for the winning bidder to have bid too high because they are the bidder with the most optimistic assumptions.

The distribution of net operating income between the owner and the lender is a choice made by the owner. When a buyer borrows a large percentage of the purchase price of the property and invests little of their own money they are choosing to “leverage” their investment, which greatly increases their risk, in the hope of gaining a greater return. After purchase, when the value of a property increases, the owner can choose to refinance and borrow additional money, increasing their risk in order to take out profits today. There is no rent level, no matter how high, that cannot be turned into a loss by over-paying, over-mortgaging or accepting loan conditions that result in higher loan costs in future years. This helps explain how it is that even when NOI is typically 60% to 65% of the rent, some landlords complain that they are not making any money.

Having taken on increased risk, when problems emerge the investor often refuses to recognize that they made overly optimistic assumptions and over-paid for a property or over-mortgaged it. Instead they blame rent controls and high local taxes and fees and often postpone necessary maintenance and renovations to maintain their cash flow. Overextended small investors frequently provide the sympathetic public face for more general efforts to weaken regulation of rental properties and lower taxes and fees.

The cost of borrowing money against the value of an investment property is not an “operating expense” because it is not a cost that is necessary for operation and maintenance of the building Instead, it is an “investment expense” and is under the control of the owner, who decides how much of their own money to invest and how much to borrow. Much of the public policy discussion about residential rental property fails to make this important distinction.

As we will see later in this report, with rare exceptions, Berkeley rental properties have net operating incomes sufficient to provide investors with far more than a “fair return” on their investment. When owners are not making a profit or else have a very low rate of return this is generally the result of their investment decisions rather than Berkeley’s rent regulations.

IV. Rent Stabilization in the City of Berkeley

Since 1980 the City of Berkeley has responded to the Bay Area housing crisis by adopting a wide range of housing programs and policies.

- Rent Stabilization and Eviction for Good Cause Ordinance
- Restrictions on condominium conversion and demolition of rental housing
- Berkeley Housing Authority Section 8 Housing Choice Voucher program
- General Plan encourages high density residential development Downtown and along major transit corridors
- Inclusionary Zoning / Density Bonus
- Housing Trust Fund (combines Redevelopment Agency funds, Federal grants from HOME and CDBG and various mitigation fees) for construction or acquisition and rehabilitation of permanently affordable housing

Initially the measure with the most impact on the housing market was the Rent Stabilization and Eviction for Good Cause Ordinance.

Rent Stabilization before Vacancy Decontrol

Berkeley has had some form of rent regulation continuously since Berkeley voters passed a temporary measure requiring landlords to rebate 80% of the Proposition 13 property tax reduction to their tenants in November 1978. Berkeley's current program began in June 1980, when Berkeley voters passed the City's Rent Stabilization and Eviction for Good Cause Ordinance. (Berkeley Municipal Code Chapter 13.76.) The Ordinance regulates most residential rents in Berkeley and provides tenants with protection against eviction without good cause. The Ordinance was intended to "protect tenants from unwarranted rent increases and arbitrary, discriminatory or retaliatory evictions" in order to maintain affordable housing and preserve community diversity.

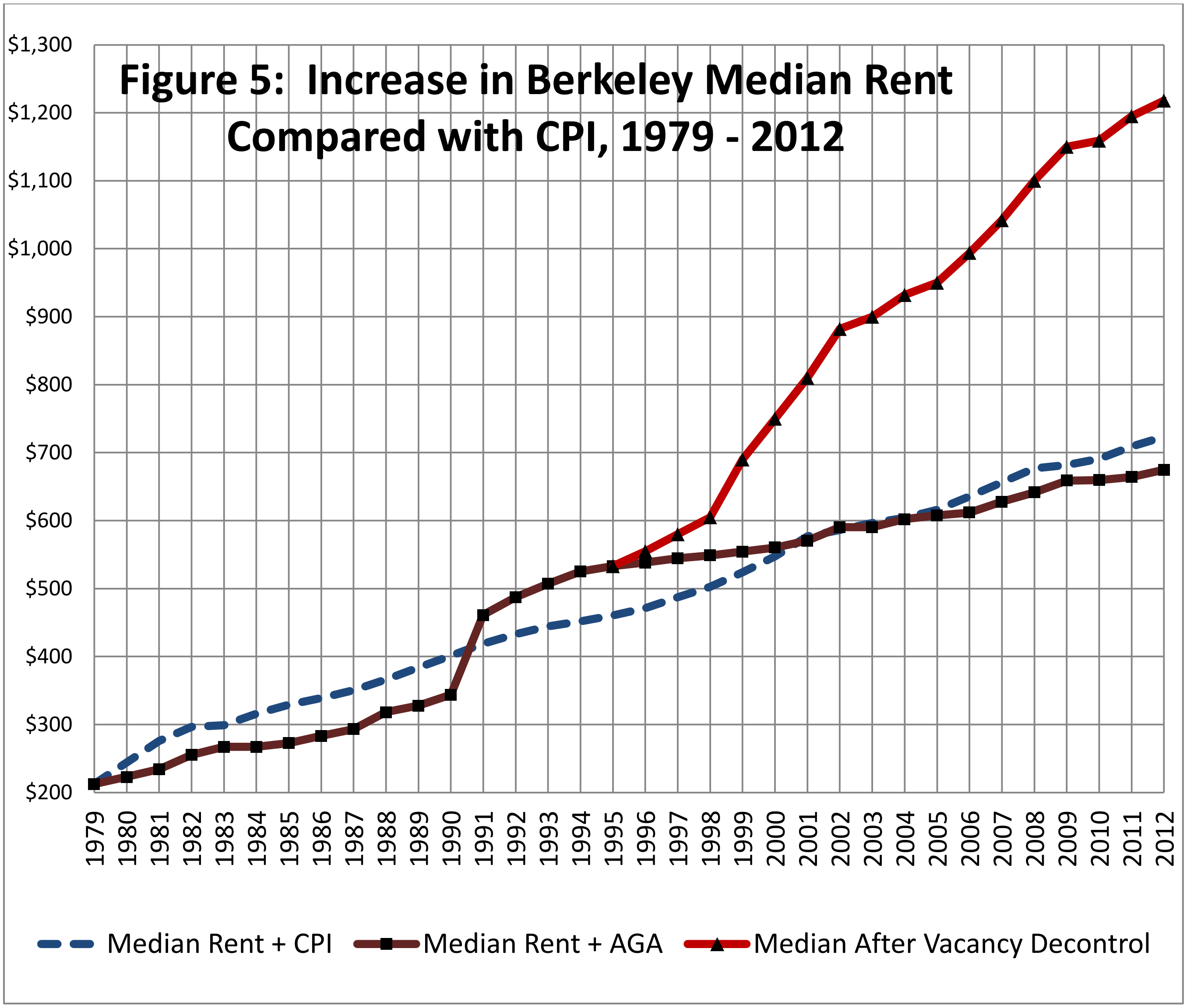
An "unwarranted rent increase" is an increase in rent beyond what is necessary in order to pay for operation, maintenance and renovation of the property and to provide the owner with a "fair return" on their investment. In other words, an unwarranted rent increase is an increase that provides additional "unearned" business revenue (economic rent) to the investors that is not based on work they or their employees do to operate, maintain and improve the property but rather on the increasing rents tenants are willing to pay due to the scarcity of rental housing in Berkeley and the San Francisco Bay Area.

The 1980 ordinance established a strong form of rent regulation that allowed rent increases only to the extent necessary to pay for increases in operating and maintenance costs and to provide an inflation adjustment for the owners' profit. It also allowed additional rent increases for major repairs and renovations after the owner presented evidence that the repairs were necessary and the costs were reasonable. The ordinance exempted new construction, so that all apartments built after 1980 are exempt from rent regulation, although they are still subject to the requirement to show good cause for evictions.

Berkeley's form of rent control, as it emerged from many court cases and political conflicts, allowed rents to increase at approximately the rate of inflation and provided owners with rents that were above the average for U.S. cities but well below the level that became typical of other cities in the central Bay Area.

Figure 5 "Increase in Berkeley Median Rent Compared with CPI, 1979 - 2012" shows what rents would be if starting in 1980 they had tracked the change in the Consumer Price Index for the San Francisco Bay Area. It compares this with the change in Berkeley rents under strong rent controls (the AGA or Annual General Adjustment) and the change after vacancy decontrol.

From 1982 to 2004 the AGA increases were based on an annual cost study and since 2005 they have been set by formula at 65% of the increase in the consumer price index. The comparison shows the major eras in Berkeley's ordinance: the strong rent control period up to 1990, in which rent ceilings lagged what they would have been if adjusted by the CPI, followed by the overcorrection of 1991, then a gradual return to the CPI as subsequent Boards compensated for the overcorrection, followed by partial and then full vacancy decontrol, and finally the change in 2004 to an AGA increase formula of 65% of the increase in CPI.



As Figure 5 shows, from 1978 to 2004 Berkeley's rent stabilization ordinance allowed annual rent increases that roughly tracked the rate of inflation. These increases were sufficient to cover increases in the cost of operating and maintaining rental properties and provided an adjustment to maintain the value of the typical landlord's cash flow. If this system had been allowed to continue, the average rent in Berkeley's rent stabilized housing today would be about the same as the average rent in Portland, Oregon, a city with a better functioning housing market.

V. Effects of “Vacancy Decontrol”

In 1995 the State of California overrode the voters of Berkeley and changed the rules, creating a three-year transition period in which rents could increase an additional 15% when a tenant moved, followed in 1999 by full “vacancy decontrol”, which allows the landlord to increase the starting rent for all new tenants without any limits. Once the unit is re-rented, future increases are again controlled for the duration of the tenancy, starting with the new initial rent, in order to provide stability to the new tenant. The new system is most accurately described as “vacancy decontrol – recontrol”.

Since 1999 fully 85% of all rent stabilized apartments have turned over at least once and the rent has increased to the much higher levels typical of the Bay Area’s dysfunctional housing market. Figure 5 shows the increase in median rent beginning with the transition period in 1996, demonstrating that rents have increased much faster than the overall rate of inflation. Today about 3,000 apartments have never received a vacancy increase because they are occupied by long-term tenants who moved in before 1999. Approximately 16,000 apartments are occupied by tenants who moved in after full vacancy decontrol and are paying a rent much closer to the current market rate.

The Rent Board’s 2010 economic study found that overall rents had increased by slightly more than $100 million annually, over and above the increases necessary to provide an inflation adjustment to cover increased costs and maintain profitability. Total rent payments in the roughly 19,000 rent stabilized apartments are now approximately $300 million annually but would have been held to approximately $200 million annually if strong rent controls had continued.

Berkeley’s tenants cope with the increased rents in several different ways. The remaining long-term tenants with pre-vacancy decontrol rents hold on to their apartments, students double up and non-student tenant households pay a higher portion of their income for rent and self-select towards those with higher incomes.

- There are 3,000 long-term tenant households who moved in before 1999 and still benefit from rents set before vacancy decontrol.
    - Long-term tenants pay an average rent of $780 monthly, substantially lower than the market rate but still higher than the average rent in all U.S. metropolitan areas.
    - Two-thirds of the long-term tenants are low-income and more than one-third are elderly or disabled.
    - Eight percent of long-term tenants said that their landlord had tried to get them to move out, compared with only two percent of more recent tenants.

- There are 16,000 rent stabilized apartments occupied by tenants who moved in after vacancy decontrol.

    - Their average rent is $1,436 monthly (as of 6/30/2012).

    - About one-third of these are rented to students and two-thirds to non-student households.

    - Students tend to deal with the higher rent levels by doubling up, two or more to a bedroom.

    - The 2009 incomes of the non-student tenants who moved in after vacancy decontrol are 11% higher on average than the inflation-adjusted incomes of non-student tenants surveyed in 1998 prior to vacancy decontrol.

    - Despite their higher incomes the 2009 non-student tenants also pay a higher proportion of their income for rent.

        - 53% pay more than 30% of their income for rent, up from 41% in 1998.
        - 28% pay more than half of their income for rent, up from 20% in 1998.

The Rent Board has also studied the extent to which the increased rental income is reinvested in renovation or improvements of buildings or paid back to the community through increased taxes. In 2012 the Rent Board studied a random sample of 68 properties containing 1,455 of the 9,700 registered apartments in properties with 10 units or more. Among the apartments in the sample 81% had received a vacancy increase and this increased the average rent per unit by $534 a month or $6,400 a year over and above the annual inflation increases that Berkeley's former strong rent control system would have allowed.

The study then examined the number and value of building permits taken out in 1991 - 1995 before vacancy decontrol, in 1996 - 1998 during the transition period, and from 1999 – 2011 after full vacancy decontrol. On the positive side, under vacancy decontrol there was a 44% increase in the inflation-adjusted value of permits taken out. On the negative side, however, the value of the permits averaged only 2% of the increased rent resulting from vacancy decontrol. Even assuming that the value of renovation work is actually triple the reported permit value, that projects out to about 6% of the $100 million increase in annual rents and only 2% of the $300 million in annual rents. Owners also reinvest some of the increased rent in the community through increased tax payments, amounting to somewhat less than 4% of the $100 million increase. Over all, it appears that only 10% of the increased rent from vacancy decontrol is reinvested in building renovations or taxes paid to local government.

Over all then, about 90% of the increased rent is going to increased profits rather than being reinvested in building improvements or in the community through increased tax payments. The additional net operating income of $90 million annually adds from $1.2 to $1.5 billion to property values. Applying a “capitalization rate” (rate of return on invested capital) of 7% to an annual $90 million in additional income results in an increase in property value of $1.28 billion, while applying a capitalization rate of 6% results in an increase in property value of $1.5 billion. Rental property values in Berkeley have more than doubled since the on-set of vacancy decontrol, although this is also partly due to declining interest rates.

Property taxes have not increased to reflect this increase in value. Only about 30% of Berkeley rental properties have been sold since 1998, leaving 70% with older valuations. Many of these will not be reassessed for the foreseeable future, being passed down within families from generation to generation or held by limited liability partnerships and corporations that are sold in fractions, all of which are ways to avoid reassessment. If all of Berkeley’s residential rental properties were assessed at their current market value, they would pay an additional $9 million to $10 million annually in property taxes.

Routine maintenance has modestly improved after vacancy decontrol, but not to the extent that might have been expected in view of the magnitude of the rent increases. The 2009 tenant survey found that fully three quarters reported that there is currently at least one physical problem in their building, down slightly from 83% in 1998, although the number of problems per building was down from an average of 3.5 per building in 1998 to 2.4 in 2009. Virtually all tenants with building problems report that they have complained to the landlord or manager about the matter during the last year and one-third of them report that at least one complaint was either not fixed or only partially fixed. Projected out to all 19,000 rent stabilized apartments this indicates that over 4,500 tenants have problems that the manager or owner has not adequately responded to.

In addition to persistent maintenance issues, there are apartments in “soft-story” buildings that are a collapse hazard in the event of a major earthquake. So far only 30% of Berkeley’s soft-story apartment buildings have been reinforced, leaving over 2,000 apartments still at risk.

As time passes, more properties change hands and this has potentially harmful effects on the reinforcement of soft-story buildings and the standard of maintenance. New buyers of rental properties often do not have the economic flexibility that long-term owners have because new buyers have generally taken out mortgages to the maximum extent that lenders will approve. Long-term owners have access to a larger proportion of the net operating income unless they have refinanced to take capital gains out of the property.

Proponents of vacancy decontrol argued that it would result in an increased supply of housing available to low-income elderly, disabled and minority tenants, greatly improved buildings, a fair profit for landlords and higher local government tax receipts that could be used to mitigate the harm rising rents cause to low-income tenants.

The recent Rent Board studies demonstrate that under vacancy decontrol:

- Rents have increased by approximately $100 million annually over and above the inflation adjustment necessary to provide owners with a fair return on their investment.
- Annual expenditures on renovation of rental properties amount to 6% or less of the increase in rent.
- Additional taxes paid are less than 4% of the increase in rent.
- In total, only10% of the increased rent has been reinvested in the community in the form of renovations or tax payments.
- The value of Berkeley rental property has doubled, increasing by $1.2 to $1.5 billion based on the increased net operating income.
- Owners of 70% of these rental properties have old assessed values that give the owners a tax break totaling approximately $10 million annually.
- Two thousand apartments remain at-risk of collapse in the event of a major earthquake and thousands more have persistent maintenance problems.

In sum, the effect of vacancy decontrol in a high-demand market with limited increases in supply has been to generate dramatic increases in rents and rental property values without adequate reinvestment and without providing resources to mitigate the economic hardship created for low-income tenants.

VI. Current Benefits of Rent Stabilization

Berkeley's Rent Stabilization Program fulfills several important roles among City housing programs including affordability, stability, education and outreach.

Affordability is provided mostly to the approximately 3,300 pre-1999 tenants whose apartments have never qualified for a vacancy decontrol increase. Berkeley's Rent Stabilization Program continues to enforce rent ceilings for these apartments that are significantly below the current market rate. Approximately 2,200 of these tenants are low income, and 1,200 are elderly or disabled. Although the number of pre-1999 tenants continues to decline as tenants age and move out, "old rent control" remains one of the City's largest affordable housing programs. The City's other housing affordability resources assist a total of about 3,900 households in Berkeley.

Low-Income Tenants Assisted by City Housing Programs

• Low-income "old rent control" tenancies	2,200 households
– Half disabled or elderly	
• Subsidized housing developments	2,000 apartments
• Inclusionary or density bonus	200 apartments
• Monthly rental assistance	2,000 households
– Housing Vouchers and Shelter + Care	
– Overlap with subsidized development	(300)
• ***Total assisted low-income households –***	***6,100 households***

Opponents of rent stabilization often suggest that all or part of the Rent Stabilization Program operating budget, which is $4,050,000 for FY2013, should be redirected to assist low-income tenants. Entirely aside from the needs that more recent low-income tenants may have for assistance, it is not hard to estimate the approximate cost of providing an equivalent subsidy to only the 2,200 low-income "old rent control" tenants in the absence of rent stabilization.

- Section 8 vouchers or a local equivalent would cost approximately $20 million annually including administrative costs. Over a twenty year period this would amount to $400 million. In effect, Berkeley would need to be able to double the size of its Housing Authority. The cost of assisting all low or even all very-low income tenants in Berkeley, including those who have moved in since vacancy decontrol, would be substantially higher.

- Alternatively, building or acquiring and rehabilitating permanently affordable housing through the Housing Trust Fund would require approximately $100,000 per unit, assuming other sources of Federal and State matching subsidy were available, for a total one-time capital investment of $220 million.

In either case, it is clear that the budget for administering the Rent Stabilization Program is not remotely close to what would be needed to meet the needs of low-income tenants in Berkeley. In addition, rent stabilization provides essential protections to more recent tenants.

Stability is provided to almost all Berkeley tenants under the Rent Stabilization and Eviction for Good Cause Ordinance. In addition to the 3,300 "old rent control" tenants, there are another 15,700 apartments, for a total of about 19,000, where rent stabilization limits future rent increases as long as the tenant remains in the apartment. In addition, if the apartment is poorly maintained, so that violations of the housing code are allowed to persist, then the tenant can petition for a reduction in rent to compensate for the violation. This strengthens the code enforcement process.

Rent stabilization combined with the requirement of good cause for eviction, provides these tenants with a stable and predictable occupancy as long as they meet their obligations as tenants. The importance of this has been shown during the financial crisis, when banks foreclosing on rental properties routinely tried to evict all of their tenants without good cause.

Yet another 2,000 tenants live in apartments that are temporarily exempt from registration because the tenant receives assistance through the Section 8 or Shelter Plus Care programs. These tenants are protected from demands by the landlord for rent beyond what the BHA or the City can help subsidize because demand for rent higher than the payment standard returns the apartment to the jurisdiction of the Rent Board and imposes the payment standard as the rent ceiling. They are also protected by the good cause for eviction requirements.

There are another approximately 6,000 rentals that are completely exempt from rent stabilization, either because they are apartments in buildings constructed after 1980 or because they are rented single-family homes or condominiums. These rentals are still subject to the requirement of good cause for eviction.

The only rental housing exempt from good cause is the small number of owner-occupied duplexes that were also owner-occupied in 1980 and cases where the tenant shares a kitchen or bathroom with the owner.

Education and outreach are important capabilities for the Rent Board. The Rent Board's registration requirements give it the ability to mail out information to both owners and tenants several times a year. In addition, the Board's housing counselors answer over 10,000 inquiries annually from landlords, tenants and the general public.

"Berkeley can be very proud it certainly has the most educated tenants in the United States." President, Berkeley Property Owners Association, *Daily Californian,* April 15, 2003.

Outreach capabilities are important for several reasons. First, Berkeley has many short-term tenants who are unaware of their rights and obligations as tenants, as well as a varying number of new landlords who also need this information. Second, the Board must be able to reach out to landlords and tenants with information about changes in regulations and procedures. Third, the Board's regular outreach makes it possible assist other city programs in reaching tenants and owners. This assistance ranges from providing information to all landlords and tenants on City services such as recycling in multifamily buildings to contacting the owners and tenants of individual buildings regarding a specific problem. In the case of the fire at Haste and Telegraph, for example, the City Manager asked the Rent Board staff to coordinate outreach to the displaced tenants, both because the Rent Board had better records for this purpose and because it had experienced outreach staff who could be diverted to this emergency from other duties that were less time-sensitive.

VII. Public Policy Challenges for the City of Berkeley

The Bay Area's shortage of rental housing generates profits for investors in residential rental property that are far beyond what is necessary to provide a fair return on investment. This creates a major transfer of income from renters to real estate investors and is accompanied by particularly serious hardship for very low-income tenants, who typically spend half or more of their income for rent. Human beings tend to assume that conditions that they live with for a long period of time are normal, necessary and justifiable, but the Bay Area housing market is not normal for the U.S. as a whole, the rents that it generates are not necessary in order to profitably operate and maintain rental housing and the effects that it has on tenants are not just.

Despite high rents and net operating incomes in rental housing, the City is not ensuring that all of this housing is as safe and well-maintained as it should be.

Berkeley's Rent Stabilization and Eviction for Good Cause Program continues to provide tenants with essential protections, but cannot do more to make housing affordable within the constraints of vacancy decontrol.

The policy challenges for the City are to find measures that will:

- Benefit low-income tenants harmed by unwarranted rent increases
- Generate greater reinvestment in rental housing to ensure safety and eliminate violations of the housing code
- Generate greater reinvestment in the community

VIII. Sources

This summary is drawn from the following studies conducted by the Berkeley Rent Stabilization Board.

- *Vacancy Decontrol and Reinvestment in Berkeley Rental Housing*, 2013
- *Rent Stabilization and Seismic Improvement for Soft-Story Properties*, 2011
- *Effects of Rent Stabilization and Vacancy Decontrol on Rents, Rental Property Values and Rent Burdens in Berkeley, California*, 2010
- *Report on the 2009 Survey of Tenants of Registered Rental Units*, 2010

The full reports are available on the City of Berkeley Rent Board's Research Reports webpage at: www.ci.berkeley.ca.us/rent/reports.

The underlying economic theory applied to the analysis of rent regulation in this report is based on the following sources:

- Lee S. Friedman, "The Control of Prices to Achieve Equity in Specific Markets", pp. 507 – 549 in *The Microeconomics of Public Policy Analysis*, Princeton University Press, Princeton, 2002.
- Andrejs Skaburskis, "The Economics of Rent Regulation", pp. 41 – 60 in Dennis Keating, Michael Teitz and Andrejs Skaburskis (editors), *Rent Control: Regulation and the Rental Housing Market*, Center for Urban Policy Research Press, Rutgers University, New Brunswick, 1998.
- Adam Smith, "Taxes upon the Rent of Houses", pp. 904 - 912 in *An Inquiry into the Nature and Causes of the Wealth of Nations,* [1776], Modern Library Edition, N.Y., 2000.