How to Fix Rent Regulation

Start with tenant abuses; finish with owner incentives; hope for political backbone

BY ROBERT KNAKAL

Welfare is defined as "financial aid or other assistance to an individual or a family from a city, state or national government." It is further defined as "receiving financial aid from the government or from a private organization because of hardship and need."

Robert Knakal
Columnist

In New York, rent stabilization is a form of welfare, rent welfare. It is a system where recipients are subsidized by everyone else in the form of higher average rent levels and higher tax burdens. While well intended to preserve affordable housing for those who are indeed in need, rent-stabilized housing is misallocated, as financial need is not part of the equation. Our rent laws provide maximum benefits to those who have been in place for a long time regardless of their financial status and need.

This results in a system that makes people resistant to moving even when, in the normal course of family life, they would seek to downsize, or to move to a bigger apartment. This limits the supply of available units, which increases the average rent a New Yorker pays. Rent regulation unfairly lowers real estate taxes collected on those properties; and residents who are not the winners of the stabilized lottery are, effectively, subsidizing those who are. This premise has been verified by studies completed by M.I.T. and at the Wharton School. Inhabitants of roughly one million of New York City's three million apartments receive rent welfare.

Unfortunately, even if every economist in the world proved to New York legislators that the elimination of rent regulation would lower average rents, it would be political suicide for any one of them to take a position against rent regulation. Generations of New York politicians continue to confuse rational housing policy with utopian social policy and do not trust the free market to do its job.

The government's stranglehold on rent regulation has kept the forces of supply and demand from allocating housing resources. The city's incessant distortion of its housing market has a political benefit to those who support regulation, as there are thousands of voters who vote on only one issue. This is the key reason why legislators fight to preserve rent regulation as opposed to letting the market naturally make the allocation. Militant tenants' associations have expertly treated mayors, council members and those in the State Assembly as their own lobbyists for permanent "affordability."

To experience the fervor of these tenants, attend one of the Rent Guidelines Board meetings that are held each spring. It is at these meetings that tenants and owners make arguments to the board regarding the need for lower or higher regulated rent increases. The most articulate tenants speak idealistically of how New York must remain affordable and accessible for everyone. In reality, their civic idealism extends no further than the walls of their own apartments.

Generally, "affordability" is attained when someone's rent equals 30 percent or less of their after-tax income. As diversity is something that is a tremendous asset to New York, the public sector must find a way to create the affordable housing that is needed. The current system of rent regulation unfairly seeks to place this public-sector responsibility on the private sector by literally hijacking private property for public use.

An owner's options to take advantage of the potential of their properties consist of high-rent deregulation, where the legal rent on a vacant unit gets to $2,000 per month, or high-income deregulation, where the legal rent reaches $2,000 per month and the tenant has earned $175,000 for two consecutive years (bills pending in the Senate would change the thresholds to $2,700 and $240,000). Either of these removes the unit from the clutches of stabilization.

Without these mechanisms to increase revenue, rent-regulated properties would eventually become insolvent, as operating expenses have increased at dramatically higher rates than regulated rental increases. From 1997 through this year, aggregate regulated rents have increased 40.4 percent while real estate taxes alone have increased by 137.1 percent.

Abuse by tenants within the system of rent regulation is widespread, and, unfortunately but not surprisingly, housing courts in New York are overwhelmingly pro-tenant. Consequently, many tenants do not relinquish their apartments after they have moved. In order to be rent-regulated, the unit must be the tenant's primary residence. After a tenant moves or purchases a home, they will often illegally sublet the apartment, pocketing the spread.

Three- and four-bedroom units, particularly in northern Manhattan, are frequently operated like mini-hotels, as the tenant will rent out unused bedrooms, often collecting more from the subtenants than they pay to the owner.

Others who can will manipulate their income to avoid earning more than $175,000 for two years in a row. A client of mine sold a portfolio of properties several years ago. We closed $8 million of the sales in one year, and the closings for the remaining $7 million were delayed for a year so that his income would not be above $175,000 for two years in a row. He lived in a three-bedroom, rent-stabilized apartment in the 70s off Park Avenue and wanted to preserve his stabilized status.

Recently, tenant advocates have been using the term "predatory equity" for investors who buy rent-regulated properties and seek to remove tenants who are illegally holding onto non-primary units, illegally subletting units, running mini-hotels out of their apartments and earning more money annually than guidelines permit. They claim owners harass tenants to move, but the simple fact is that if a regulated tenant is in possession of a unit legally, he or she has absolutely nothing to worry about. These owners are simply trying to identify tenants who are unfairly taking advantage of the system. Because of these abuses, the pro rata cost of operating an apartment often exceeds the rent that is being paid on that unit, placing additional pressure on owners to weed out the cheaters.

In January of this year, the New York State Assembly passed a package of bills to modify and strengthen rent regulation to an even greater degree. Perhaps the most troubling of these bills was the one that would limit the benefit to owners when they make major capital improvements (MCI). For those of who weren't around in the 1970s, this city witnessed widespread abandonment of multifamily properties, and entire neighborhoods were torched, leading to decay and blight.

To address this problem, the MCI pass-through was created, which established an incentive for private-sector investment by allowing regulated rents to increase by 1/84th of a unit's pro rata share of the cost of the improvement. As a result, billions of dollars have been spent to upgrade properties. The quality of the housing stock has become significantly better, and our real estate tax base has increased significantly. The pending bill would marginalize the MCI benefit, making it merely a surcharge until the money invested is recouped. This would have a devastating effect on our local economy. There would be little incentive for an owner to do more than patchwork repairs to buildingwide systems, resulting in thousands of construction-related job losses and a deterioration in the quality of our housing stock.

Rent-regulated apartments should be allocated based upon need. As rent stabilization is a form of welfare, all stabilized tenants should be required to submit tax returns to become eligible to occupy a rent-stabilized apartment.

First, I would propose that the income hurdles be based upon the higher of last year's earnings (using adjusted gross income to include capital gain and dividend income), or a three-year average. Anyone earning more than $135,000 should be moved immediately to free-market status at the expiration of that lease. This level of income is chosen because, based upon current federal, state and local tax rates, $2,000 per month would be affordable for that resident at less than 30 percent of after-tax income. This would immediately increase real estate tax collections and free up supply, placing downward pressure on free-market rents, as explained in the Wharton and M.I.T. studies.

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Second, a minimum rent should be established for every rent-stabilized unit, which should be a pro rata percentage of operating expenses. Clearly, operating expenses should not include capital expenditures, and general and administrative expenses would have to be capped at a fixed percentage to dissuade owners from overloading operating expenses. Tenant contributions to that rent should be capped at 30 percent of their income-hurdle amount, protecting the affordability of that unit. If the tenant's cap is below the minimum rent level, the government should provide a subsidy to make up the difference. The incremental increase in real estate taxes received could form a fund out of which the subsidy could be paid for.

Third, modifications to rent regulation could be used to stimulate our local economy through private-sector investment, increased construction jobs and increased real estate tax collections. Modifying the individual apartment improvement (IAI) bonus of 1/40th increase in rent level to 1/36th would create additional incentive for owners to increase the renovation work done to individual apartments. And this would not impact any in-place tenants.

Fourth, the cost of MCIs should be passed along to regulated tenants in proportion to the tenant's ability to pay. Under this program, rather than 1/84th of the cost, MCIs' increases would be passed along at the rate of 1/48th, constrained by the ability of the tenant to pay the increased rent. The rent that a tenant would pay could be capped at 30 percent of their after-tax income, thus leaving the unit at an affordable rent for that tenant, provided the increase is at least 1/84th. Environmentally sensitive improvements could be passed along at an even healthier rate.

These last two suggestions would create tremendous incentives for owners to improve the quality of their buildings while keeping rents at affordable levels for tenants.

Last year, approximately $500 million was spent on IAIs and MCIs. These program modifications could potentially add $250 million in private-sector investment to our economy. This is a 100 percent private-sector-funded stimulus program that would increase jobs for New Yorkers, particularly in the construction industry. Given increased property incomes, it would also increase the real estate tax base and collections.

Being a realist, I don't expect any politician to endorse any of these ideas. However, rent stabilization should be for those who are clearly in need. Abusers of the system place an undue burden on the rest of our residents, who are left paying more taxes and higher rents simply to subsidize those who were in the right place at the right time. These suggestions attempt to transform our system to one that remains more fair for all New Yorkers while providing affordable housing for those who truly need it.

rknakal@masseyknakal.com

Robert Knakal is the chairman and founding partner of Massey Knakal Realty Services and has brokered the sale of more than 1,000 properties in his career.