

## Rent-Reg Racket Reaches Fever Pitch

### Will pols man up? System stymies tax revenue, squeezes regular renters

BY ROBERT KNAKAL

In 2009, perhaps the most interesting trend in the city's multifamily market was that both median and average sales prices per square foot for walk-up buildings exceeded those of elevator buildings.

Interestingly, this counterintuitive dynamic was observed in each borough. In Manhattan, we saw walk-ups average \$530 per square foot; elevator buildings averaged \$507; and, in Brooklyn, \$160 versus \$121.

There are three explanations for this trend. First, the tenancy for turnover in walk-ups is significantly higher than in elevator buildings. Residents aspire to live long-term in elevator buildings; walk-ups tend to have a more transient tenant base. This higher turnover rate allows owners to access the embedded upside potential within these assets. Second, the room sizes in walk-ups tend to be much smaller than similar bedroom-count units in elevator buildings. Third, due to the smaller room sizes, the rent achievable per square foot is actually higher, in many cases, in walk-ups.

This trend illustrates the significant problems with our current system in New York. Simply put, rent regulation does not serve the city well and, in fact, creates a system in which the non-regulated residents, in the city and across the state, subsidize those who benefit from regulation.

We must realize that rent regulation is not an affordable-housing program as many tenant advocates would have you believe—it is a tenure program designed to allow residents to have continuity in their living arrangements over an extended period of time. If rent regulation is to serve as an affordable housing program, substantive changes must be made. The present program is tragically flawed and will inevitably implode without thoughtful reconstitution.

It is not unexpected to hear right-leaning economists dismiss price controls as poor policy. However, New York's rent-regulation system is so dysfunctional that even liberal economists feel the program is destructive to the tax base and the quality of the housing stock.

Consider the following insights from some of the world's leading liberal economists: "That great sacred cow—Rent Control—is a textbook case of economic stupidity."—*The*

*New York Times'* Paul Krugman; "In many cases, rent control appears to be the most efficient technique presently known to destroy a city except for bombing."—Assar Lindberg of *The Political Economy of the New Left*; "Rent control has in certain Western countries constituted, maybe, the worst example of poor planning by governments lacking courage and vision."—Gunnar Myrdal, the Swedish economist. These are some powerful words from surprising sources.

So why do economists agree that the rent-regulation system is flawed? The basic reason is because we must understand that rent-stabilized and rent-controlled housing is misallocated. The benefits go to New Yorkers based upon inertia rather than economic ability. Financial need is simply not part of the equation.

The 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 upgrade the size of their apartments. This constrains the supply of available units, which puts upward pressure on the average rent that a New Yorker pays.

There have been studies conducted at MIT and at the Wharton School demonstrating that in the absence of rent regulation, the average rent in New York would be reduced significantly. There are currently 3.35 million dwelling units in New York City. Approximately 1.4 million of these are occupied by rent-regulated tenants. Therefore, the eight million residents of this city fight over only about two million realistic choices for living space, as opposed to the 3.35 million in the total stock. This constrained supply exerts upward pressure on rent levels.

Taxes paid by nonregulated homeowners (single family homes, condos and co-ops) and market rents paid by nonregulated residents are both higher than they should be, due to the artificially lower real estate tax collections and due to the low rents paid by regulated tenants. In effect, every rent-regulated tenant is being subsidized by every nonregulated resident.

This illustrates one of the biggest fallacies traditionally put forward as the reason why there is no political will to "do what's right" relative to rent regulation. It has always been

said that there are more tenant voters than property-owner voters, and therefore, politicians simply won't stand up for substantive modifications to the rent-regulation system.

However, there are almost 1.5 nonregulated residents for every regulated resident. Therefore, there are actually significantly more non-regulated voters than regulated voters. Awareness of this reality and of the significant subsidy nonregulated residents are paying must be part of an industry initiative moving forward. Do upstate residents really enjoy paying more in order for wealthy Manhattanites to benefit from artificially low rents?

The current rent-regulation system simply does not work. Operating expenses have been increasing at rates significantly in excess of regulated rent increases. At present, 10 percent of regulated properties have expenses that exceed income, not including the calculation of any debt service. We expect this condition to worsen over time.

Massey Knakal is conducting a study of growth rates of expenses in multifamily buildings over a 25-year period versus the growth rate of regulated rents. For example, when I started in the business, in 1984, real estate taxes were about \$1 per square foot. They are now in a wide range of \$6 to as much as \$13 per square foot, a 600 to 1,300 percent increase. The one-year Rent Guidelines Board (RGB) increases have totaled 97 percent, or 149 percent on a compounded basis. We are looking at each expense category to determine the year in which a majority of rent-regulated buildings will be insolvent, notwithstanding debt service.

Given these economic realities, is there any wonder why owners need to aggressively root out tenants who abuse the system? The term "Predatory Equity" is laughable. Owners are simply doing what is necessary to keep up with the meteoric rise of real estate taxes, water and sewer charges and other operating expenses.

Regulated rents are simply not keeping up with expense growth, as there are gross miscalculations in how the RGB determines rental increases. They examine, on an annual basis, a basket of operating expenses established in 1983. While they try to extrapolate how these expenses have grown over time, the basket is not modified to include new expenses created by legislation, such as complying with local law 11, lead paint regulations and removal of as-

bestos. The basket of expenses considered must be expanded to meet today's reality.

There is also a deficiency in the way the expenses in the basket are calculated. For instance, if it is estimated that a plumber should visit a building 1.2 times per month, and last year that plumber's wage was \$X, and, if this year, that wage has increased, the expense calculation is simply the 1.2 visits multiplied by the new increased wage. However, the building stock continues to age, and as a building gets older, it would make sense that the plumber would have to visit more than 1.2 times. This adjustment is not used, thereby understating the real growth rate of operating expenses.

In the absence of sweeping changes to the system, the housing stock in New York City is destined to look very different in the decades to come. Given the ballooning operating expenses of multifamily owners, it would not be surprising to see almost all elevator buildings converted to condo or co-op at some point in the future, as owners pass along the expense burden to tenants.

Programs to develop new, desperately needed affordable housing must be created. Some say the cost of building new units is too expensive for the city. If so, appropriate economic incentives need to be established to provide the private sector with the ability to keep some of the existing stock affordable. We cannot, however, allow tenant advocates to succeed in encouraging politicians and policy makers to steal private property for public benefit.

The rent-regulation system also needs a defined set of rules if it is to survive. Recently, the Roberts decision in the Stuytown/Peter Cooper Village case rocked the industry. The biggest travesty of this decision is that well-established rules, and the rule enforcers, were undermined. For 13 years, the Division of Housing and Community Renewal (DHCR) had issued highly relied-upon opinion letters indicating that regulated units in properties receiving J-51 tax abatements could be deregulated. DHCR is the police department of the rent-regulated multifamily housing world. The decision told us that the police didn't know what they're doing.

Moreover, the Department of Housing Preservation and Development (HPD) is the police department of the J-51 program. HPD would routinely reduce the amount of the J-51 benefit based upon the number of units that had been deregulated, effectively ratifying the rules established by DHCR. This breakdown in rules is disruptive to the market,

creating significant uncertainty.

Yet another decision creating havoc in the market is a recent court ruling stating that the RGB did not have the authority to provide owners with the ability to collect a low-rent supplement on units renting for less than \$1,000. The RGB has been the rule maker for regulated rent levels for decades. Advocates fought this supplement, saying that it would adversely affect low-income tenants. Unfortunately, their argument makes no sense, as no one knows the income level of tenants paying under \$1,000 per month. No one can say with certainty that there are not millionaires paying less than \$1,000 per month in some units. I, personally, know two.

This brings up a necessary component of modifications that need to be made to New York's rent-regulation system: means testing. Means testing would accomplish a lot and has many indirect benefits. Opponents claim that this would be too unwieldy to administer. All New York residents file state tax returns, don't they? Tenants in Section-8 units and those in the 20 percent component of 80/20 buildings have to "qualify." Why shouldn't all regulated tenants have to qualify?

Qualifying would ensure that the benefits of rent regulation would be granted only to those who truly need them. It would also greatly reduce what advocates call "harassment." I have never seen an illegal regulated tenant walk into a management office and say, "I have a primary residence in Westchester and use my regulated unit one or two weekends per month." Nor has anyone said to the building owner, "I am illegally subletting my regulated unit to make some extra cash on the side." Often, the only way to determine who these cheaters are is to initiate legal action.

There is a tremendous opportunity approaching in 2011 as regulation comes up for renewal. Means testing and making tenants qualify would benefit many. Those who need the benefits would get them. Owners could spend a lot less time and money searching for abusers. Importantly, sorely needed real estate tax revenue would increase. We could see some relief in rent levels as market-rate tenants have more options from which to choose. The time is now; will anyone have the guts to take action?

[rknakal@masseyknakal.com](mailto:rknakal@masseyknakal.com)

Robert Knakal is the chairman and founding partner of Massey Knakal Realty Services and has brokered the sale of more than 1,050 properties in his career.



Robert Knakal  
Columnist