CONCRETE THOUGHTS

The Good, the Bad and the Endlessly Ugly of Rent Regs

What Albany continues to get wrong about housing welfare—and what it should be doing to make things right: first up, means testing

Robert Knakal

While the recent extension of New York's rent-regulation system came as no surprise to the vast majority of participants in our multifamily market, the results were still disappointing and have left many owners concerned that if this is the result obtained with a Republican-controlled Senate, what would occur with Democrats in power? Yes, the renewal terms could have been much worse, but that doesn't diminish the negative implications this has on our housing market.

Let's take a look at the terms of Chapter 97 of the Laws of 2011 and their potential impact.

Recently, legislators voted to extend New York's rent-regulation system until June 15, 2015. Let me begin by saying that I am an advocate for affordable housing in New York. The diversity of our population is a key ingredient to the vibe of the city, and quality housing for those occupying the full range of the socioeconomic spectrum is critical.

Unfortunately, this piece of legislation is perhaps the most ill-conceived and inefficient public subsidy program Albany has ever enacted. Rent regulation is just that, a public subsidy akin to welfare or food stamps that allows some residents to receive benefits randomly. Distribution of the benefit is based on inertia (and often luck) rather than economic need, as people staying put the longest are the most likely to receive benefits. This system leads to a gross misallocation of our housing stock.

In past Concrete Thoughts columns, I have used the analogy of having the city hand out food stamps randomly to everyone walking out of Grand Central as a better-conceived program for distributing public assistance. The subsidy handed out under rent regulation is, in some cases, enormous and may be given to those who have absolutely no need for it.

Price controls of any type create problems for a marketplace. With regard to rent regulation, the misallocation of housing occurs because, with rent levels artificially depressed, the real estate taxes collected on properties with these controls are artificially less than they should be, creating artificially higher real estate tax burdens on all New York residents who are not rent-regulated.

Additionally, while there are about 3.3 million dwelling units in New York City, about one million are regulated, essentially leaving 2.3 million options for someone looking to move into the city. This constrained supply leads to free-market rents being artificially higher than they would be otherwise. Rent-regulated tenants are reluctant to move, often leaving a family of five cramped in a small two-bedroom apartment and an individual tenant occupying a six-room apartment. In the absence of controls, it would be much easier for these tenants to find appropriately sized units, priced appropriately.

The most significant changes to the recently renewed law include making it much more difficult to remove units from the subsidy program under both types of luxury decontrol (high rent and high income).

The high-rent decontrol threshold was raised from $2,000 per month to $2,500. Under this rule, vacant apartments with legal rents in excess of $2,500 per month are no longer subject to rent regulation. Notably, any units that were deregulated due to rents being above the old guideline of $2,000 per month are not reregulated if they are currently renting for less than $2,500. This change took effect on June 24 and the threshold will apply even if the next tenant, or any subsequent tenant, pays a rent under $2,500.

Why shouldn't all rent-regulated tenants be required to prove eligibility to receive this public subsidy? After all, I don't think anyone wants to see a protected tenant with a modest income get displaced, or to see grandma on fixed income get kicked to the curb by Mr. Potter.

With respect to the other form of luxury decontrol, the high-income threshold was increased from $175,000 to $200,000. This threshold applies if that income level is achieved by the tenant for two consecutive years and the legal rent exceeds the $2,500-per-month hurdle. This element of the law is completely backward.

Consider this: Any nonregulated resident of New York is effectively subsidizing all regulated tenants. If an apartment has a free market value of $2,700 per month and a rent-stabilized tenant is paying $2,450 per month, upon lease renewal this tenant's rent will exceed the $2,500 threshold. If that tenant has earned more than $200,000 for the past two years, that unit will become deregulated. However, the subsidy that all nonregulated residents are paying is about $200 per month.

If, however, a tenant earning over $200,000 per year is paying only $700 per month, the subsidy all nonregulated residents are contributing toward is $2,000 per month, a much more burdensome figure. This is why if a tenant is making over $200,000 per year (and some may be making millions per year) he or she should be deregulated if his or her rent is under $2,500 per month, not over $2,500 per month. Does anyone really need public assistance if they are making over $200,000 per year?

Additionally, manipulation of income to skirt this aspect of the law is quite easy and is the reason why a three-year income-averaging approach should be used. I had a client once who sold over $7 million of investment properties in one year and delayed the closing of an additional $5 million of properties the following year until after Jan. 1 simply to protect his $1,200 three-bedroom on 74th Street off Park Avenue. Obviously, this is an extreme example, but you get the point.

This new high-income threshold kicked in on July 1. The old hurdles of $2,000 per month and $175,000 of income will still apply for all proceedings commenced prior to July 1 of this year.

Why shouldn't all rent-regulated tenants be required to prove eligibility to receive this public subsidy? After all, I don't think anyone wants to see a protected tenant with modest income get displaced, or to see grandma on fixed income get kicked to the curb by Mr. Potter. Means testing would eliminate many of the inefficiencies within the system and eliminate much of the litigation that regularly occurs between owners and tenants, making for a more harmonious relationship between the two.

Tenant advocates claim that means testing is "too cumbersome" to implement. That's crazy. Any tenants receiving Section 8 benefits must prove their eligibility. So, too, must residents within the 20 percent component of 80/20 buildings. Most residents file New York State tax returns, making this process relatively easy. Placing the burden of proof on the tenant would eliminate much of the alleged "harassment" that occurs when an owner initiates litigation to determine the tenant's income. While advocates see this as harassment, there is really no other way for an owner to determine a tenant's income.

An additional tangible change to the law impacts the mechanism related to Individual Apartment Improvements. For buildings containing fewer than 35 units, the I.A.I. guideline remains at 1/40th of the improvement cost as a monthly adjustment to the rent. In buildings with more than 35 units, the passthrough has been lowered to 1/60th. This change takes effect on Sept. 24, 2011, but the language in the law is unclear and will undoubtedly be subject to interpretation by the state Division of Housing and Community Renewal or, perhaps, the courts.

The timing of the change is linked to the Sept. 24 date "where such adjustment takes effect." Presumably, this means a time no sooner than the date of completion of the work, but does it mean when the work is indeed completed? The date the lease is signed? The date the tenant moves in?

The biggest problem with the new 1/60th rule is that it erodes an underlying incentive to encourage the private sector to upgrade the quality of the housing stock. After hundreds of buildings were abandoned or burned during the 1970s, I.A.I. and the Major Capital Improvements increases motivated private owners to pump billions of their dollars into multifamily properties, which led to the generally excellent quality of today's housing stock.

Fortunately, the M.C.I. passthrough was not altered as proposed by a bill passed by the New York State Assembly, which would have reduced the M.C.I. increase to a subsidy that would evaporate after repayment. That would have been devastating for the market.

The Rent Guidelines Board recently passed a 3.75 percent one-year increase and a 7.25 percent two-year increase for leases beginning in September. The sublet allowance was maintained at 10 percent. Additionally, the vacancy allowance remained at 20 percent; however, it can be used only once in any calendar year. It is unclear whether any other increases are possible within that calendar year if the vacancy bonus is utilized.

The rules regarding preferential rents remained unchanged as it was confirmed that preferential rents are only for the period of the lease in question.

Two other items the industry was hoping would be part of this extension would address the 421-a and J-51 programs. The 421-a was extended, with certain limitations, provided that any eligible development must apply to the city for a Preliminary Certificate of Eligibility before June 23, 2012. Unfortunately, the uncertainty regarding the fate of J-51 buildings was not addressed. This would have been a perfect time for a legislative solution to the quagmire created by the Roberts decision. A judicial solution will likely take years, leaving the fate of thousands of units unclear.

Our rent-regulation system provides protections for hundreds of thousands of people who need and deserve the protection. Unfortunately, there are probably hundreds of thousands of others who do not need this subsidy, and that leads to adverse conditions for all nonregulated New Yorkers. Why not ask that recipients of this subsidy demonstrate that they qualify for this benefit?

A combination of higher rents and higher taxes burdens the system unnecessarily. As property values dropped during this recession, real estate taxes continued to increase substantially each year, leaving an increasing percentage of multifamily property owners feeling like they are working a lot harder for a lot less.

The adverse components of rent-regulation renewal add to the frustration felt by owners. A combination of these dynamics had resulted in a growing number of investors with substantial holdings here looking to purchase properties outside of New York. This is not a good trend for our marketplace or our city.

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