

HOUSING AFFORDABILITY

Policies and consequences



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Affordable housing is becoming more and more of a trending issue, and lack of affordable housing is at crisis levels in many metropolitan areas. In response, policymakers are embracing bold initiatives that will dramatically change residential and multi-family real estate markets. Two of these policy initiatives – rent control and elimination of single-family zoning – deserve a closer look at how they work and what consequences might be anticipated.

Rent Control

Price controls are government restrictions limiting prices that can be charged for goods or services. Price ceilings on rental real estate are commonly referred to as "rent control," although there is a technical difference between rent control (which sets an upper limit to actual prices) and rent stabilization (which is more common and limits price increases). For our purposes, "rent control" will be used to refer to any laws that restrict rents to other than market levels, regardless of whether accomplished through price caps or limits on rent increases.

Rent regulation has often resulted from wars, most notably after World War I and particularly following the Second World War, which gave birth to the modern era of rent control starting in New York City in 1943. This spread to other large cities such as Los Angeles and San Francisco following the end of federal price controls during the inflationary 1970s. Most states in the U.S. affirmatively prohibit rent control, while a number of others have no rent control. Only Oregon and California have statewide rent control (both enacted in 2019), while California also has a number of municipalities with separate rent control laws—similar to New York, New Jersey, Maryland and the District of Columbia.

Rent control laws vary significantly, but these are the primary features:

- Strict *price ceilings* were a hallmark of early rent controls, but have mostly been replaced by rent stabilization. This scheme is still in place for pre-1947 units in New York City, provided the tenant or lawful successor has occupied the unit consistently since at least 1971 (about 2% of regulated units citywide); maximum base rents are determined every two years. And in Europe, Berlin last year imposed a five-year rent freeze on 1.5 million units citywide.
- *Rent stabilization* is the typical method of regulating rents by limiting price increases, usually on an annual basis. In Los Angeles, annual increases can fall within a range of 3- 8% plus 1% each for gas and electric utilities, if provided by the landlord; San Francisco allows annual increases based on changes in the Bay Area CPI, plus increased utility costs if paid by the landlord. Recently-passed state laws in Oregon and California limit annual increases to a fixed percentage plus inflation; in Oregon it is CPI plus 7%, while in California it's CPI plus 5% (not exceeding 10% total).
- Rent control laws typically allow landlords to pass through the cost of *capital improvements* as rent increases, but such increases are usually subject to approval by the agency or local board overseeing the rent control ordinance.
- *Specific categories of units are normally covered by rent control*; single-family homes and condominium units, for example, are often excluded. Most rent control laws also exempt newer construction on the theory that developers will still build new rental housing as long as it isn't rent controlled. New laws in California and Oregon both exempt buildings constructed over the last 15 years.
- *Vacancy decontrol* is a fairly standard feature of modern rent control ordinances, allowing rents to increase to market when a unit is vacated. Vacancy control regulates rents between tenancies and was a feature of original rent control laws in Santa Monica, West Hollywood and Berkeley, but was eliminated by California's Costa-Hawkins Act in 1995.
- Most rent control laws limit the landlord's ability to evict a tenant, with *evictions normally subject to "just cause"* (like failure to pay rent). There is usually a provision for no-fault evictions (for example, if the owner wants to move in or remove the unit from the rental market), which often entails the payment of relocation assistance to displaced tenants. In some cases, landlords simply offer tenants money to vacate ("cash for keys").

The arguments for and against rent control are well-known. Tenant advocates focus on social justice, arguing that housing is necessary and costs are unaffordable for working-class residents, requiring government protection from what are believed to be unfairly high rents. And there is no question that the biggest beneficiaries of rent control are existing tenants, who are incentivized to stay in rent-controlled apartments (studies have shown that tenants in controlled units have longer tenures). Property owners, on the other hand, offer an economic argument that holding rents below market equilibrium increases demand and reduces supply, resulting in a shortage of new units, deterioration of existing units and higher prices in the uncontrolled market (not to mention

lower investment returns). Developers have less incentive to build and owners of existing properties have less incentive to maintain or renovate their buildings, often driving existing housing off the rental market; studies have also shown that lack of new construction deprives municipalities of property tax revenue. Both sides' arguments have merit – rents are unquestionably high in many metropolitan areas, but housing shortages under rent control are quite real. Consider that after rent stabilization was introduced in New York City in 1969, construction of housing dropped substantially and many existing units were simply abandoned; in Cambridge, Massachusetts, on the other hand, repeal of rent control in 1994 resulted in a significant increase in residential investment citywide.

Rent control is dynamic. Rent control that once existed in some places (the United Kingdom and Cambridge, Massachusetts) has been repealed. Statewide rent control was recently enacted in Oregon and California, even though California voters rejected a measure to repeal statewide rent control limits (Costa-Hawkins) in November 2018. Proposals to lift state prohibitions on rent control died in Colorado and Illinois, even as tenant groups there continue to lobby for local rent controls. And in Europe, a rent freeze was recently implemented in Berlin. Additionally rent controls were imposed in France, Spain and the Netherlands, with proposals to reintroduce rent control in the United Kingdom.

California's new law (AB 1482) was signed in October 2019 and is illustrative of how statewide rent control will work. The law's effective date was January 1, 2020, and its scope on existing landlord-tenant law is immediately apparent from the first words "Notwithstanding any other law . . ." Allowable annual rent increases for existing tenancies are 5% plus inflation (as determined by the regional CPI), retroactive to March 15, 2019, with the ability to reset rents to market upon tenant turnover (vacancy decontrol). For tenants occupying a unit continuously for 12 months, evictions are limited to just cause, or "no-fault just cause" (intent to occupy by owner or family members, withdrawal

of unit from the rental market or intent to demolish/remodel the property), upon payment of relocation assistance equivalent to one month's rent. Exempt properties include homes and condominiums unless owned by a REIT, corporation or LLC in which at least one member is a corporation; duplexes if one unit is owner-occupied; housing with a certificate of occupancy issued within the previous 15 years; and properties already covered by more restrictive local rent control ordinances. The law has a 10-year sunset date, but does require a report by the Legislative Analyst on or before the expiration date regarding the effectiveness of the rent caps on the state's housing market. It isn't hard to conjure up a scenario where statewide rent control becomes permanent in California.

Housing Density and Single-Family Zoning

Economics tells us that high demand and inadequate supply leads to increased prices, which are necessary to allocate a scarce resource among those who desire it (recall the four factors that create value in the marketplace: utility, scarcity, desire and effective purchasing power). It is exactly this issue driving proponents of affordable housing to suggest radical changes to residential zoning to accommodate more supply. This is based on the theory that the increased supply will cause prices to decrease, thereby producing more affordable housing.

Regulation of land use started in the late 19th century with Los Angeles passing the first municipal zoning ordinance in 1908, and the first comprehensive zoning code adopted in New York City in 1916. Zoning ordinances are often referred to as "exclusionary," as they exclude all but specified land uses from identified zoning districts; this scheme is common throughout most communities in the United States (e.g., R-1 zoning for detached housing). Over the decades, population growth was often accommodated by urban sprawl. However, in recent years interest has grown in more urban density, usually in downtown areas and around transit hubs. In an effort to promote construction of more housing, opponents of exclusionary zoning are now taking aim at this sacrosanct concept, particularly the notion of having only a single home on a building lot (single-family zoning).

The best case study for this idea is what has recently transpired in Minneapolis, as it confronted its own affordable housing crisis. Roughly 70% of land in Minneapolis is zoned for detached homes, similar to many other cities across the country. In 2014, the city took the preliminary step of allowing "accessory dwelling units" (ADU's) or granny flats in single-family neighborhoods. From there, it didn't take long for the next step where the City Council approved the Minneapolis 2040 plan in December 2018, becoming law in October 2019 and effective in January 2020. The new law effectively ends exclusionary single-family zoning citywide, allowing up to three units on any residential lot (but maintaining yard space and height requirements), also increasing housing density near transit stops, eliminating off-street parking requirements and requiring 10% of units in new apartment projects to be set aside for moderate-income households.

Proponents of eliminating single-family zoning advance three major arguments: increased supply would lower prices and make housing more affordable; it would foster social justice by reducing economic segregation; and it would reduce urban sprawl and support public transit, thereby combatting climate change. Common objections often center on how such proposals would destroy existing neighborhoods, and the simple creation of more housing doesn't necessarily mean that such housing would be affordable. And there is some support for the latter argument, as zoning reform in New York City in the early 2000s produced nearly 200,000 new apartments that were not particularly affordable. Up-zoning in Chicago over the past 10 years produced little investment in low-income neighborhoods, and a surge of market-rate apartment developments in Los Angeles has produced mostly high-priced rental housing.

Municipalities around the country are nonetheless looking at variants of this idea. Seattle, for example, has created Urban Villages in areas with employment access and good transit. Seattle recently up-zoned residential land in these areas to accommodate greater density, though affecting only a small percentage of the city's single-family housing. A more ambitious rezoning plan was ultimately scaled back among fierce opposition from neighborhood groups.

At the state level, Oregon and California have become the first states to embrace modification of single-family zoning, effectively usurping land use control, traditionally a local prerogative. Oregon's law (HB 2001) was signed in August 2019, affecting nearly 70% of the state's residents living in urban areas, including Portland where 77% of land is



zoned for detached homes. It allows up to four units on single-family zoned lots in cities of 25,000 or more and two units on such lots in cities with population of more than 10,000—generally similar in concept to what was done in Minneapolis.

California's law (AB 68) was signed only two months later (and the day following the state's rent control law). The law does not go quite as far as Oregon, at least not yet, despite the state needing 1.8 million new housing units by 2025. California already permitted one accessory dwelling unit appurtenant to single-family properties based on several bills in 2016-17 that required ministerial (rather than discretionary) approval at the local level, limited the imposition of parking requirements and required local ADU ordinances to conform to state guidelines. The new law, however, now permits up to two ADU's on any lot with single or multi-family residential zoning statewide, without regard to minimum lot size, coverage, FAR or allowable density; provides that such units are a residential use consistent with the general plan and zoning designation (whether true or not); that can be attached or detached (with specified size limitations); and with relaxed parking requirements. Importantly, ADU's can be rented separately, a concept approaching a standard multi-family residential use. Other legislation (AB 670, also enacted in 2019) voids any provision in the governing documents of a planned development (like a condominium project or master-planned community) that would prohibit or restrict the construction or use of ADU's, effectively limiting the ability of homeowners' associations to regulate these units.

Noting Minneapolis' stepwise approach to abolition of single-family zoning, California has also been toying with the idea of further expanding statewide housing inventory via increased density near employment or transit hubs and/or allowing up to four units on most residentially-zoned lots (similar to what Oregon did for cities of 25,000 or more people). Variants of these proposals have been around since January 2018, with SB 827 dying in committee in April 2018, SB 50 failing in a vote before the State Senate in January 2020 and SB 902 introduced immediately thereafter. The tenacity of the bill's proponents suggests that the idea isn't likely going away soon.

The Valuation Angle

There is little question that the evolution of affordable housing policy will affect the valuation of affected properties. In the case of California and Oregon, this will include most residential properties in the respective states.

Rent control is not new – appraisers and market participants in municipalities with rent control are usually quite familiar with how the local ordinances affect value. In Los Angeles, for example, a rent controlled property is generally not comparable to an otherwise similar exempt property, and contract (not market) rents are normally used to capitalize income for such properties (acknowledging that tenants with below-market rents are often incentivized to not give up their apartments). Appraisers statewide will now be confronted with the realities of rent control. For example, can a sale in 2020 be compared to a sale in early 2019 (pre-rent control)? An article published by Real Capital Analytics late last year suggests that investors and lenders are repricing assets in markets where rent control exists or is being introduced. If contract rents are significantly below market, the following questions are important to consider:

- Is contract or market rent typically used by market participants for income capitalization?
- What is the ratio of contract to market rent for the subject and comparables, and how does it affect price metrics?
- How long before the subject property can attain a market rent level?
- If using market rent for valuation, is a rent loss analysis appropriate?

For properties with accessory dwelling units, should these properties be valued as single-family homes with one or two guest units or should they be valued in the same manner as multi-family residential? Does it matter whether the ADU's are occupied by family members or paying tenants? For an owner-occupied home with one or two rented ADU's, is it possible to value the property as a single-family dwelling, with contributory value of the accessory units determined by the income approach? And if California eventually goes the way of Minneapolis and Oregon in doing away with exclusionary single-family zoning, what kinds of highest and best use questions will have to be addressed for every appraisal of a single-family residential property?

Some of these questions are easier than others, but they all represent a new paradigm as government increasingly utilizes policy tools to combat a growing crisis in housing affordability. ⚡



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