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REALITY CHECK

Want Cheaper Rent? End Rent Control

By Amanda Williams, 02/03/2012

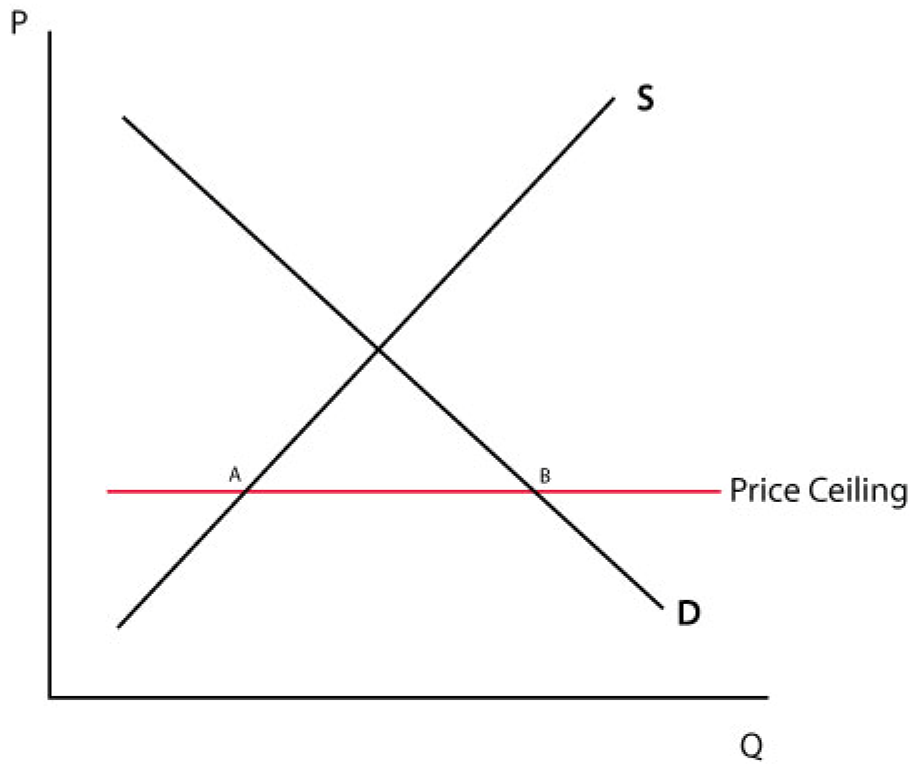
The Supreme Court may have a chance this year to determine whether rent control is constitutional or whether it represents a "taking" without just compensation. A topic worthy of debate—but in my view, there are sound economic reasons rent control (like many government regulations), however well intentioned, is woefully misguided. To see why, let's return briefly to Economics 101.

Anyone who took an economics class will likely have (possibly painful) flashbacks in examining Exhibit 1, which shows a generic supply and demand graph, with price and quantity on the x- and y-axes, respectively. Basic economic theory expects a supply curve to slope upward because the higher the price a good's provider can obtain, the more he's willing to supply. On the flip side, demand for most goods is downward sloping because, on average, consumers are less-inclined to consume higher quantities of a good the more it costs. The intersection of the two determines the price and quantity the market supports (commonly known as equilibrium).

Exhibit 1's red line represents rent control—effectively, the price ceiling or maximum price landlords (or whoever is supplying whatever good in question) may charge. What happens to supply and demand? Well, since producers cannot legally charge the price a freely operating market would support, they overall choose to supply less of the good (for our purposes, housing) to the market—represented by the point where the supply curve intersects a hypothetical price ceiling (point A).

Compounding the market distortion, because the price is held artificially low, consumers in general demand more of the good (housing)—where the demand curve intersects the price ceiling (point B)—than is supplied. Meaning competition for open apartments becomes increasingly stiff and even well-qualified prospective tenants likely find it difficult to find adequate housing in rent-controlled cities (never mind less-competitive tenants like new college graduates with little credit or salary to recommend them).

Exhibit 1: Supply and Demand With a Price Ceiling



For illustrative purposes only. Not drawn to scale or based on actual data.

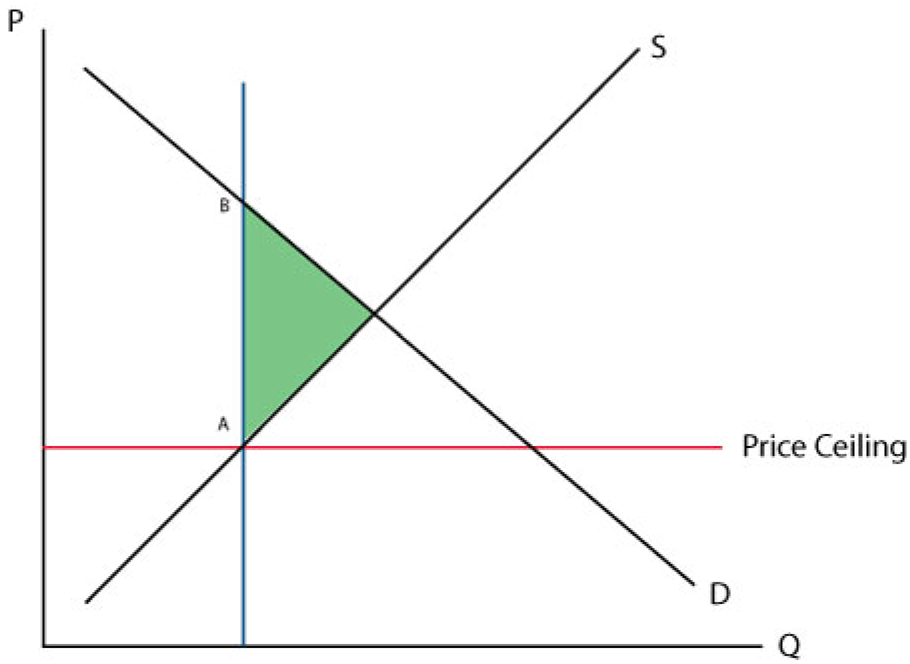
Market distortions aside, though, rent control has for years been generally considered a tenant-friendly policy—one that supposedly helps keep housing in high-density, popular cities like San Francisco and New York, ahem, "affordable."

If you're snickering, you intuitively understand price ceilings like rent control create distortions in both halves of the market—supply and demand—which ultimately hurt landlords and tenants alike. Look first at supply. Mandate a maximum rent landlords can charge and they'll likely supply less housing—particularly in cities like New York or San Francisco where property prices, taxes, general maintenance and a whole host of costs are particularly high. Rent-controlled units can bring in rents as low as half the market value (or sometimes lower), making it very possible landlords actually lose money on rental properties—a strong disincentive for landlords to provide sufficient supply to meet cities' demand.

Now, some might argue that cost to landlords is worthwhile given renters' benefit. But here's the real rub: Renters are hurt by rent control, too! (Bet you never heard that at a Rent Stabilization Board meeting!) Consider the point where the blue line in Exhibit 2 intersects the demand curve (point B)—that essentially represents the level of demand and the price renters would be willing to pay at the lower supply landlords provide under a rent control regime. Notice the price is higher (potentially significantly so) than the equilibrium price would be. Meaning when landlords are able to raise the rent to market level (which in most cases they can upon realizing a vacancy in the building), they can actually obtain a higher price than they would without rent control because the demand is so high relative to the quantity supplied. In other words, because supply's constrained, vacant apartments attract such demand the rent can actually increase above an optimal, free-market equilibrium. (Curses—foiled again!)

Ultimately resulting in increasingly bifurcated cities—where some tenants who've lived in their units for years pay significantly under-market rents, while new renters may pay more (possibly much more) than they would in a city sans rent control. (A conclusion Zuccotti Park's occupants would no doubt have reached had they been allowed to remain.) No doubt far from what rent control's proponents originally had in mind and contrary to what most believe—which is typically that pernicious, greedy landlords are simply trying to gouge their tenants. But urban folklore aside, landlords are likely on average your typical rational economic beings—meaning they, too, are subject to capitalism's binding rules of supply and demand, for better or worse.

Exhibit 2: Demand at a Fixed Supply



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One final point before leaving our graphs: There's a measureable, societal loss of economic efficiency under rent control regimes. The green-shaded triangle represents economic loss—meaning there are more renters who could be renting and landlords who could be leasing were it not for the price ceiling. Economists refer to this area as deadweight loss—and that benefits no one at all; not even the government.

Fortunately, as hinted at the outset, the Supreme Court may soon have an opportunity to determine whether rent control constitutes a "taking" by government without just compensation. In my view, it clearly does. Consider: Rent control laws mandate landlords provide housing at what amounts to a subsidized rate, without in any way compensating landlords for the lost rent. Frame or justify it how you will—to me, that's pretty clearly the government taking private property without consent or compensation. And I'd argue there are few constructs of our American system more sacrosanct than the protection of private property, making this Supreme Court case especially momentous.

But you don't even have to agree with those arguments to see the trouble with rent control—because as this brief economics refresher demonstrated, rent control also represents something of a taking from renters' and even the government's perspectives, though perhaps in a less readily transparent manner. After all, without rent control, states likely realize increased tax revenues as property values improve because rents return to more market-like levels (something New Jersey has apparently recently begun realizing on its own).

Whether the case makes it to the high court remains to be seen, but it's an important step in the right direction, in my view—and one long overdue. I certainly hope the Supreme Court seizes the opportunity this case presents—it would be a great win for private property rights and for overall freer markets.