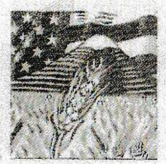
How to Kill a Housing Market



CROSS COUNTRY
By Joshua Stein

New York Gov. Andrew Cuomo signed a law in June expanding the state's damaging and counterproductive rent regulations. Driven by tenant-rights activists who want to keep rents low for the minority of New Yorkers who live in rent-stabilized apartments, the law targets what activists call a "loophole" allowing property owners to raise rents—potentially to market levels—when they make major capital improvements to their buildings or to individual apartments.

In response to the new law, New York property owners immediately began making decisions that, when played out across tens of thousands of apartments, will add up to a disaster for everyone—not only landlords.

I spoke with one of those landlords over breakfast not long ago. He owns a medium-size portfolio of older buildings in middle- and lower-middle-class New York neighborhoods. Among his properties is a large building in northern Manhattan. For more than 40 years, one of the building's apartments—a two-bedroom—was occupied by a tenant paying about $800 a month. That barely covered the apartment's share of the building's operating costs and ever-rising taxes, water, and sewer charges. The apartment would be worth about $1,800 a month on the free market, if offered in good condition.

The tenant recently died. After four decades of wear and tear, the apartment needs some work. Long-term tenants of this type typically don't let owners into their apartments to do nonemergency repairs. They don't like the disruption.

Before the new law, the vacancy would have entitled my friend the landlord to a "vacancy-bonus increase" of about 20% a month, about $160. Then for every $15,000 spent on improvements, he could have raised the rent permanently by an additional $250 a month. That's a good return on incremental investment.

A bathroom upgrade costs about $10,000 and a kitchen about $15,000. My friend could have invested another $10,000 or so to repair damage, replace doors and finishes, and upgrade electrical circuits. Those investments could have brought the rent to about $1,700. The apartment's next tenant could have moved into an improved, not fancy, two-bedroom with a somewhat below-market lease, still protected from increases by rent stabilization.

The new law ensures that won't happen. It gives property owners no vacancy-bonus increase. For every $15,000 my friend spends on improvements, he can raise the rent by only $83.33 a month. Even that shrunken rent increase will go away after 30 years. If he makes any investment in the apartment exceeding $15,000 in any 15-year period, it will be money he isn't legally allowed to recoup. He won't be allowed to raise the rent further. Whoever lucks into that apartment will pay only about $900 a month, half the market rate.

New York state tightens the screws on landlords, who will respond by letting apartments go vacant.

My landlord friend could rent the two-bedroom to a family willing to accept the apartment nearly as is. But if one family member leaves, another would have a "right of succession" and be entitled to stay at the same rent. So a string of family members would probably stay there forever at around $900 a month, the rent rising ever so gradually over time while the building's maintenance costs and tax bills rise faster. Eventually, the new tenants will almost certainly complain about the apartment's subpar condition, which will require the time and attention of building management and city agencies.

Here come the unintended consequences: My friend now says he won't invest a penny in the apartment, because doing so makes no economic sense. Instead, he plans to hold it vacant and wait for better days. Maybe Albany will figure out it made a huge mistake and reverse course. Maybe the courts will recognize that rent regulation represents a taking of private property without compensation and violates the Constitution. Maybe my landlord friend will accumulate adjacent vacant apartments and combine or reconfigure them.

For now, though, a perfectly good Manhattan apartment stays empty.

If other property owners see things the way my friend does—and simple arithmetic suggests they will—New York's new rent-regulation law will decrease rather than increase the number of affordable apartments available in the city. Tens of thousands of New Yorkers would gladly rent my friend's two-bedroom for $1,700 a month. Mr. Cuomo and the Democrats who run Albany won't let them.

As building values drop, producing loan defaults and foreclosures, real-estate tax revenue will also plummet. Construction workers will feel the squeeze too, as property owners elect not to invest in their buildings. But the true victims will be those who rent (or want to) in unregulated buildings, who will find it harder than ever to find an affordable apartment.

Mr. Stein is a commercial real estate attorney whose clients include owners of rent-regulated buildings.

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