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Economic Primer & Policy Analysis:
Rent Control Policies & Oregon SB-608

Rent control policies are controversial. They create significant winners and losers and raise serious questions about the prioritization of certain segments of society with others and economic concerns with moral ones. With such dynamics, it is a given that there are no easy answers, at least not to those not given to ideological posturing. The fact is that housing is both an economic system and a human one, with very real ramifications for those involved, which just happens to be everyone.

In 2019, the State of Oregon passed SB-608, a bill intended to address two primary concerns: rental cost growth and tenant evictions. While the law applies to the entire state, it was largely a response to conditions in Oregon's largest city and metropolitan area, Portland. In some ways, it follows a long line of rent control policies in place in many jurisdictions in the United States, but it differs markedly from most of these.

This report will lay out some of the basic dynamics that relate to short-run increases in demand and policies such as rent control meant to address them. It is frequently established in economic literature that rent control policies create inefficiencies in the housing market. Some of the most common will be addressed here, before concluding with an overview of SB-608 and how it relates to and addresses these concerns.

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INTRODUCTION

In 2019, the State of Oregon passed SB-608, a bill intended to address two primary concerns: rental housing cost growth and tenant evictions.[1] While the law applies to the entire state, it was largely a response to conditions in Oregon's largest city and metropolitan area, Portland. While similar in some ways to rent control policies enacted elsewhere in the United States, Oregon's policy differs markedly from most of these in some key ways. In fact, it might be a stretch to even label the new legislation a 'rent control' policy at all. Unlike many other such laws, it doesn't freeze rent or keep rental housing costs below long-term equilibrium. Further, the rent growth cap is only one line of a larger bill intended to protect renter tenants from possible abuse by landlords in hot housing markets. In this report, we will discuss the motivating factors that drove the creation of this policy, the economic fundamentals of rent control measures and their implicit inefficiencies, and how SB-608 addresses these issues in its construction.

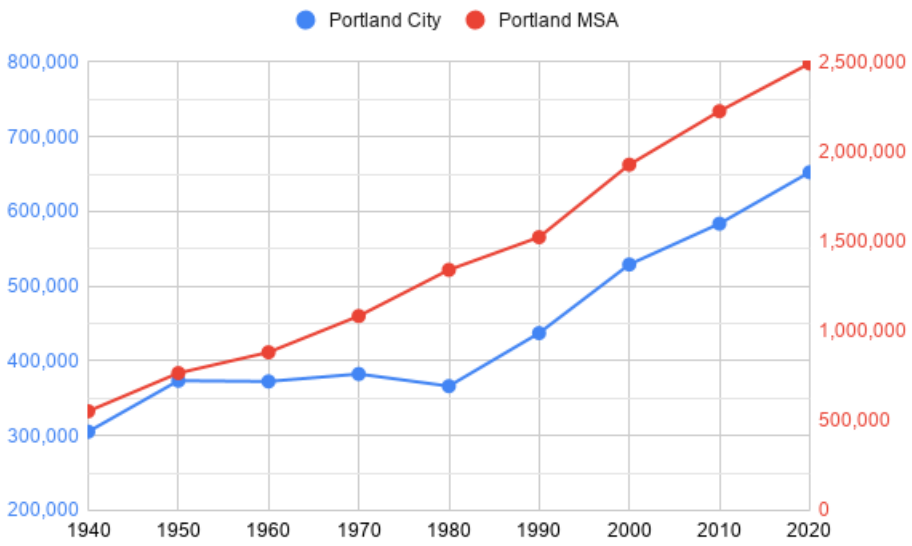

Figure 1: Portland population trends (1940-2020). Source: American FactFinder, census.gov.

Portland's demographic trends mirror many American cities in the era following World War II. After the War, the city suffered from significant disinvestment as residents flocked to the suburbs. While the larger metropolitan statistical area (MSA) continued to grow – and its urban form developed mostly in the form of

[1] Senate Bill 608, 80th Oregon Legislative Assembly, 2019 Regular Session, https://olis.leg.state.or.us/liz/2019R1/Measures/Overview/SB608.

detached single-family housing – the city itself largely stagnated (Figure 1). Without new residents, housing supply in the city itself dried up and deteriorated. Like many American cities, however, Portland saw a resurgence of population growth after the 1980s as younger people began choosing to return to the city. And while new construction did increase during this period, it hardly matched the continued decline of the existing housing stock (Figure 2).

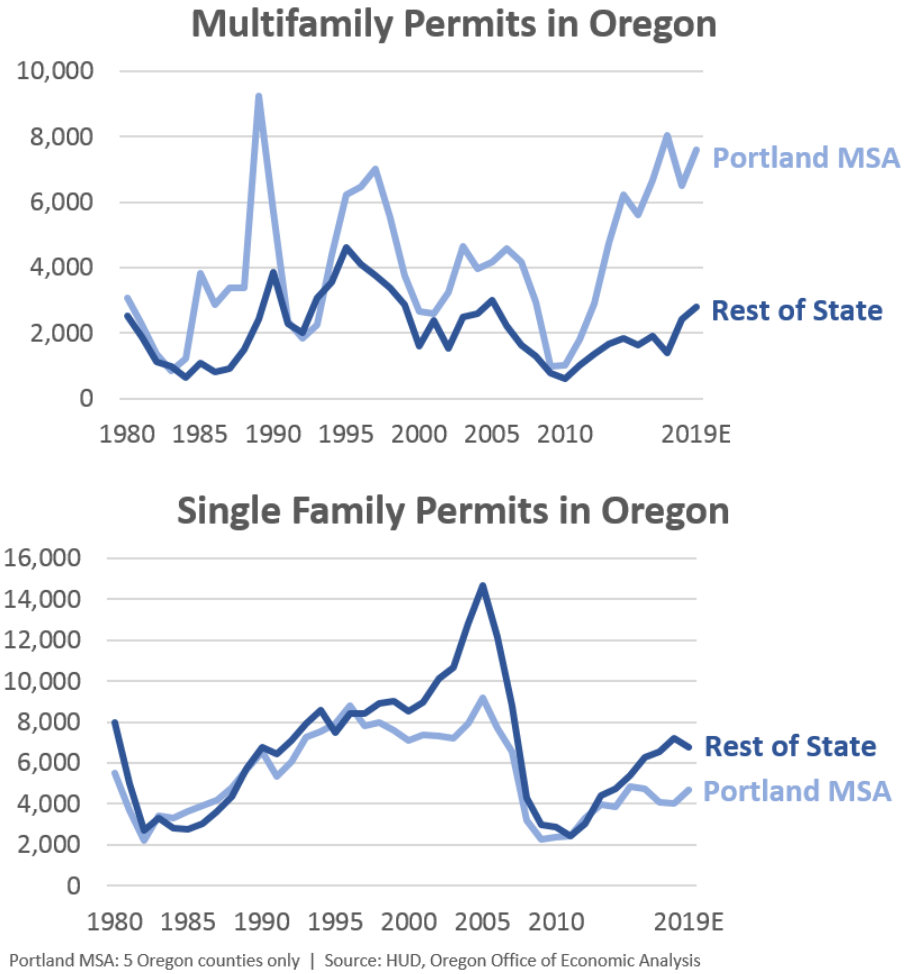

Figure 2: Residential permits in Oregon. Source: Oregon Office of Economic Analysis.[2]

This discrepancy led to rising costs as demand outpaced new supply. This trend rapidly accelerated following the Great Recession as Portland's population

[2] Oregon Office of Economic Analysis, "Update on Oregon Housing Starts," October 2, 2019, https://oregoneconomicanalysis.com/2019/10/02/update-on-oregon-housing-starts/.

boomed. Since housing supply trailed demand (as is common), housing prices skyrocketed, straining the budgets of existing residents whose wages were not increasing at a commensurate rate, often leading to increased displacement. This dynamic drove calls for policy solutions to address ballooning costs for rental housing, though there was only limited movement on the political front until the past few years, culminating in SB-608.

Before discussing the specific provisions of SB-608, this report will lay out some of the basic dynamics that relate to short-run increases in demand and policies such as rent control meant to address them. It is frequently established in economic literature that rent control policies create inefficiencies in the housing market. Some of the most common will be addressed here, before concluding with an overview of SB-608 and how it relates to and addresses these concerns.

ECONOMIC FUNDAMENTALS: RENT CONTROL

Rent control policies can be viewed through a short-term and a long-term lens. More often than not, rent control policies are proposed as a reaction to localized short-term increases in demand pinching existing supply.[3] The resulting rapid price increases can have tremendous effects on households given the scope of housing costs in most household budgets, especially when paired with slower-growing or static wages. In Figure 3 below, we've modeled such a scenario.

In this model, we show short-term housing supply as perfectly inelastic, that is that quantity is constrained to existing levels. This assumption is based on the long lead time inherent in housing supply. We have also shown the long-run supply under the assumption that housing is a fixed production cost enterprise (that is producing each extra unit of housing costs the same as the previous, an assumption we will relax when we look at rent control from a longer-term lens). Under these assumptions, an increase in demand from D to D' yields a price increase from P_0 to P_S as an increasing number of potential tenants are bidding on a limited supply of rental units. This price increase is captured by landlords in the form of economic rent, that is payments in excess of their costs (maintenance plus opportunity costs). The economic rent is called quasi-rent, which landlords will continue to collect until supply expands from Q_0 to Q_L and price returns to equilibrium.[4]

[3] Lee S. Friedman, *The Microeconomics of Public Policy Analysis* (Princeton, NJ: Princeton University Press, 2002), 516.

[4] Friedman, *The Microeconomics of Public Policy Analysis*, 517.

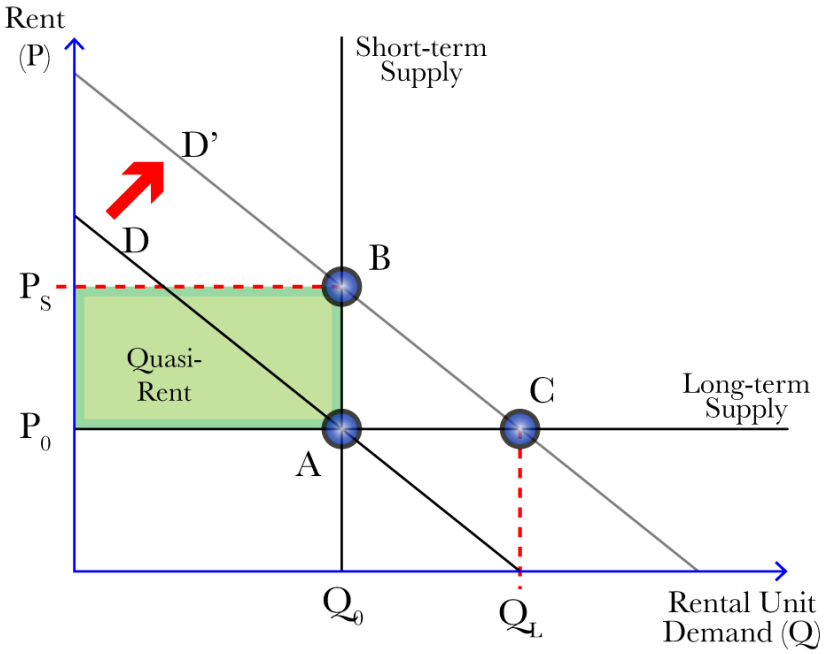

Figure 3: Short-term rent freeze in response to demand increase.

Under the conditions of such a surge in demand, a jurisdiction can impose a rent freeze, holding price at P_0, in which case quasi-rent shifts from suppliers to tenants, as those in units can sell the rights to those units to those bidding for them.[5] In such a model, in the long-term, supply also expands to Q_L and the market is once again at equilibrium. Under these assumptions (short-term and fixed-cost supply), there is no inefficiency in rent control policies, only a question of distribution of the quasi-rent either to landlords or tenants, in which case questions of political economy will dominate the discussion.

Now looking at our model with a longer-term view (Figure 4), we can relax our assumptions about fixed-cost supply. In truth, housing supply costs do increase in the long-term as increasing production drives increased construction wages and supply costs, generating an upward slope.[6] Under these assumptions, the demand surge initially drives a price increase from P_0 to P_S, once again yielding quasi-rent to landlords as residents bid up the price for rental units. In the long-term, supply will expand from Q_0 to Q_L and price will reach equilibrium at P_L. But as before, the initial surge in price creates intense market pressures on residents as rent soaks up more and more of budgets that are not expanding at a commensurate rate, driving

[5] Arthur O'Sullivan, *Urban Economics*, 8th Ed. (New York: McGraw-Hill Irwin, 2012), 401.
[6] Friedman, *The Microeconomics of Public Policy Analysis*, 519.

political support for rent relief measures. If a rent freeze is put in place at the initial price, P_0, supply will not expand as the cost of producing new housing is above the imposed price, creating a perceived shortage of housing equal to Q_0-Q_{DC}, the quantity demanded at the imposed price. This distortion creates significant deadweight loss equal to the triangle ABC, though it does shift what would be increased producer surplus at the market equilibrium C to consumers (rectangle P_LP_0AO). In such a circumstance, landlords and housing suppliers are undoubtedly losers at they see their potential surplus reduced by P_LP_0AC. However, tenants might be gainers or losers under such a policy, depending on whether their gains from the shift of P_LP_0AO from producers to consumers is greater than their loss of consumer surplus from deadweight loss, represented by triangle OBC.[7] Such a rent freeze in the long-term is dramatically distortionary and does produce significant economic inefficiency, especially as demand continues to increase due to demographic shifts and population growth without expansion of supply.

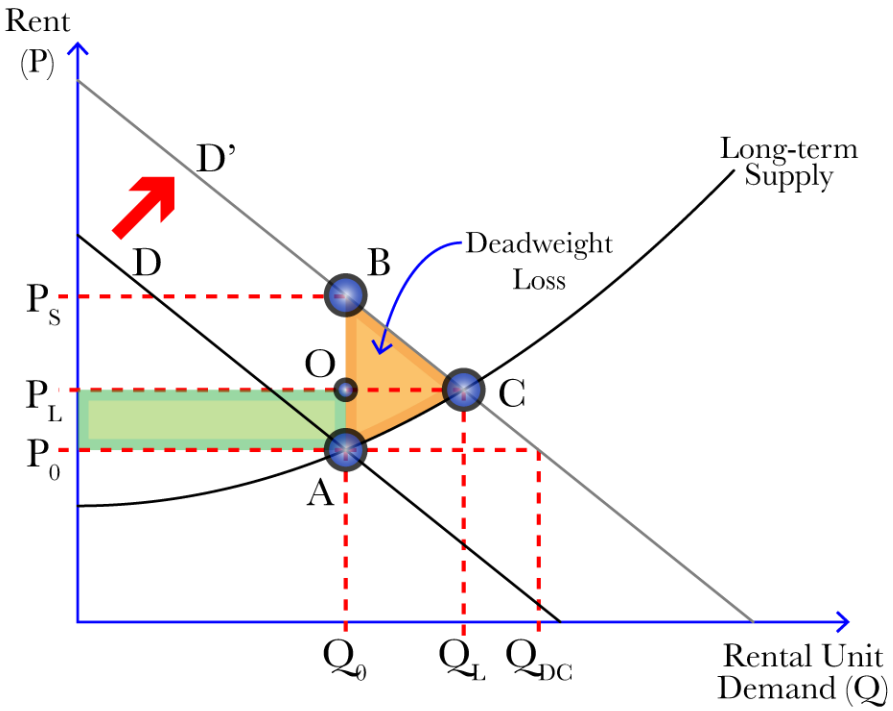

Figure 4: Long-term rent freeze in response to demand increase.

[7] Friedman, *The Microeconomics of Public Policy Analysis*, 519.

An alternative to a rent freeze would be a rent control policy that allows price to rise to the equilibrium level in the long-term but prevents a dramatic price shift in the short-term. Such a policy would contain the economic rents that are created but still allow supply to expand as long as the policy does not keep rents below market equilibrium in the long-term. This would significantly reduce the economic inefficiency of the policy while still protecting tenants from damaging housing cost increases. Oregon's SB-608 looks more like this policy option as it allows rental price increases of 7% + CPI (consumer price index). Such a ceiling allows prices to rise as supply, maintenance, and opportunity costs, rise but prevent the price gouging that might occur under the circumstances Portland has experienced since the Great Recession.

RENT CONTROL INEFFICIENCIES

In addition to the fundamental price distortions and attendant economic inefficiencies possible with rent control policies, there are a few other market inefficiencies and inequities that are worth mentioning. In this section, we will briefly discuss the distortions and consequences of rent control policies on housing exchange, capitalized property values, housing disinvestment, and land use conversion. Each of these have subtle effects that tend to add up over time and across geography to detract from the effectiveness of rent control policies.

Housing Exchange

Rent control policies create disequilibrium in exchange for housing. In general, the distortionary effects of rent control policies create a discrepancy between some units or renters and others, leaving room for a deal, which while improving overall efficiency, never quite captures the total economic loss generated by such policies. This can create significant equity issues (particularly in regard to horizontal equity) that are often left unaddressed by rent control proponents by creating winners and losers.[8]

Who bears the burdens of these inefficiencies depends on the specific contours of the policy, though broadly speaking, it falls on whether the policy centers tenants or housing units as the target of control. In cases where the unit is the target of control, it creates an incentive to buy into those units by paying some other agent, whether an existing tenant, the landowner, or a rental agent to gain access to a controlled unit. For example, if a newcomer would save $1000 by moving into a rent-controlled unit, they might be willing to spend upwards of $900

[8] O'Sullivan, *Urban Economics*, 401.

in order to access that unit and still come out ahead. In this case, the economic rent that the policy is intended to capture is simply moved around from one agent to another, with some loss attributed to the transaction.[9]

In cases where tenants are the beneficiaries of control, there is an incentive to remain in the same unit to maintain the price discount, regardless of whether that unit is ideal for the tenant. This decreased mobility not only locks up housing units but creates further inefficiencies that would be avoided if the tenant were not disincentivized from finding a more appropriate housing situation. For example, a couple moves into a unit and becomes the beneficiary of a price discount from rent control as long as they stay in that unit. However, as time moves on, the couple's circumstance changes (a new job in further from their home, a change in income, children). In a free market with minimal transaction costs, this couple might relocate to another unit (closer to work to decrease transportation costs or to a bigger unit to accommodate children), but under rent control centered on tenancy, the price discount might be significant enough to deter them. Not only does this affect their utility maximization, but other people for whom that unit might otherwise be available are subject to reduced market options.

A second concern for policies that center on tenancy is an increasing gap between what a renter is charged in rent and what the market would bear if left uncontrolled. This burden falls principally on the landowner, who in such circumstances has a significant incentive to find means to evict the tenant in order to restore rent to market rates. This is one reason Oregon's SB-608 includes significant protections for tenants, especially those whose tenure matures past the first year.

Capitalized Property Values

The loss of economic rent to landowners from rent control policies is not distributed evenly. Such policies create winners and losers among that group as well, often without regard for ability to weather such circumstances. By capping rent or rent increases, these policies create distortion in the housing market for owners as well by decreasing expected revenue. This decrease in revenue is captured in the capitalized value of the property. The capitalized value is price paid for the property accounting for future value, which includes potential revenue from rental. With rent controls in place, rental properties are worth less because the expected value of that property over the life of ownership is reduced.[10]

[9] Friedman, *The Microeconomics of Public Policy Analysis*, 524.
[10] Friedman, *The Microeconomics of Public Policy Analysis*, 530.

However, this loss only accrues to current owners. This is important since current owners, assuming they bought a rental property with the intent to rent, paid the previous owner based on the capitalized value pre-control. Therefore, an owner who sells a property just prior the imposition of rent control is paid for the expected future revenues of that property by converting it to cash at sale, revenues which the new owner will not realize. The new owner will then be subject to a potentially significant windfall loss. This horizontal equity issue is augmented by a potential vertical equity issue, in that large landowners, including large banks and property developers, are more likely to have a diversified portfolio and more able to weather the capital losses on some properties, whereas a small-scale landowner paying a mortgage based on the capitalized value of the property pre-control will see revenues decrease, possibly below what enables them to maintain the property.

Housing Disinvestment & Land Use Conversion

Another potential inefficiency intrinsic to rent control policies is the market distortion related to housing investment. If rent control policies reduce potential rental revenue and therefore the capitalized value of a rental property, the opportunity cost of investing in rental housing development increases substantially.[11] If that opportunity cost (the potential revenue from a different investment) eclipses the expected capitalized value of the rental property, that property will not be developed as such, further constraining available supply and increasing market rental prices, exacerbating the shortage that the policy was meant ameliorate.

The dynamic between capitalized value and opportunity cost also applies to current rental properties. If rent increases are insufficient to keep the potential capitalized value of a rental property above that of other uses, that property will be converted to another use. Figure 5 models such a scenario. This figure shows how such policies affect demand for rental properties, all other land uses, and the combined demand for all land uses. In this model, the reduced revenue potential of rental properties acts to reduce the overall demand for those properties. However, demand for non-rental properties is unaffected. As rent falls from P_0 to P_1, the quantity of rental units on the market also falls from Q_R to $Q_{R'}$. Since the total land supply is finite and inelastic, the rent decrease converts those lost units to other uses, increasing their quantity from Q_O to $Q_{O'}$.

[11] Friedman, *The Microeconomics of Public Policy Analysis*, 521.

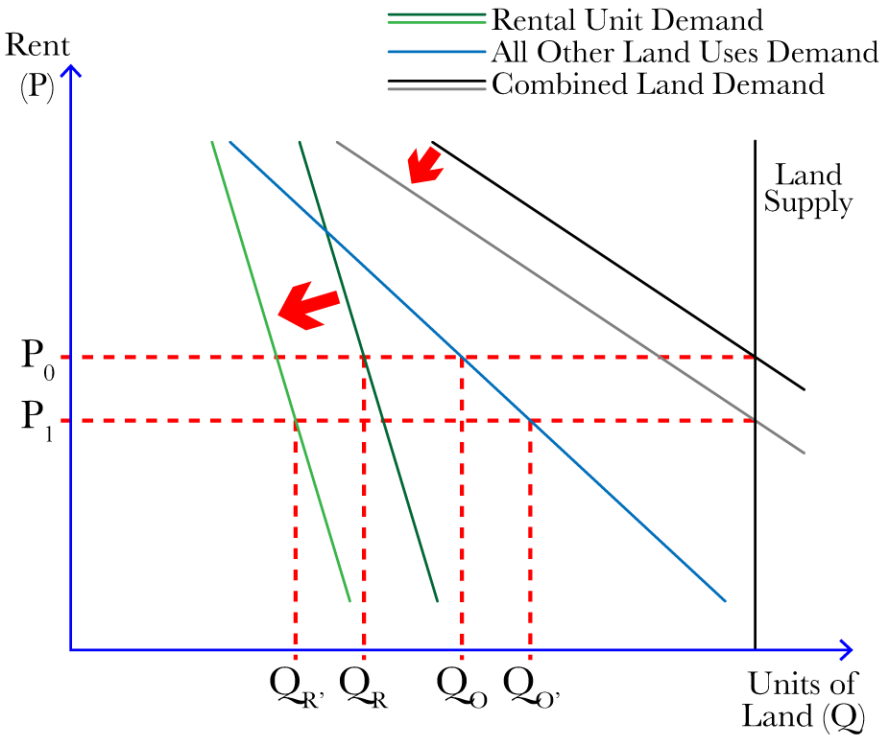

Figure 5: Rent Control & Land Use Conversion.

This model reveals the importance of the setting of the allowed rent increases for maintaining properties in use as rental units. Per Friedman, "Allowed rent increases must be sufficient to keep the capitalized value of the property greater in apartment use than in any other use. If not, the landlord has an incentive to change the use. Rent control ordinances that allow only building costs and maintenance expenses to be passed on to tenants will generally cause inefficiency in the long run."[12] This is one reason why SB-608 sets the increase cap at 7% + CPI. This way, it will capture not only increases in the cost of maintaining the property, but also accounts for the opportunity costs associated with the investment. If the potential value of other investments, property or other, were superior, disinvestment in rental properties would yield long-term hazards to the housing market.

[12] Friedman, *The Microeconomics of Public Policy Analysis*, 536.

OREGON SB-608

It is evident that the authors of SB-608 were cognizant of many of these inefficiencies, as several are clearly addressed in the legislation. The first and most notable to many people is the rent increase cap. As Tenants United has noted in its editorials on the topic, the cap of 7% + CPI is less rent stabilization and more a measure to prevent price gouging.[13] However, it is likely that this is exactly the intention of the authors. Aware of the market failures caused by caps that prevent prices from rising to the long-term equilibrium and the disinvestment that can result from potential capitalized value falling below other opportunities and uses, the authors set the increase cap at a level that allows for long-run increases to cover both maintenance and other opportunity costs. And while the organization is correct in that 7% + CPI is greater than the overall growth of rents in the entire state through the housing crunch, it would have prevented the most egregious increases in Portland, where it is most applicable. And while rent freezes are best in short-term circumstances and when implemented at the onset of a crisis, the hope is that this order will remain inert by default but capture future circumstances that could create similar hardships.

Figure 6: Cost growth of rental housing in Portland, OR. Source: cityobservatory.org.[14]

[13] Portland Tenants United, "Senate Bill 608: The Good, The Bad, and The Ugly," February 13, 2019, https://medium.com/@ptu/senate-bill-608-c87a76a76650.

[14] CityObservatory. "Portland rents are going down," July 23, 2018, http://cityobservatory.org/portland-rents-are-going-down/.

It is also worth noting that there are further nuances to the rent increase cap. First, the cap does not apply to properties in the first 15 years after being granted a certificate of occupancy. This primarily addresses the disinvestment question. By excluding new construction, initial owners can benefit from a higher potential capitalized value, preventing a decline in development of new rental property. And since it applies to the certificate of occupancy and not only initial construction, significant renovation or rehabilitation of older properties are also excluded, keeping such projects as viable investments. Second, rent may be reset on a change in tenant, but only if the previous tenant leaves voluntarily. This provision is one of many imposed in the legislation to protect existing tenants from the incentive to landlords to evict in order to maximize rent revenues.

While the headline of the bill is certainly going to be the rent increase cap, the majority of the bill deals with eviction protections. And as we have discussed in this report, such protections can help evade some of the worst inefficiency outcomes of rent control policy, particularly those mentioned in the section on housing exchange. Under the bill, no-cause evictions are banned after the first year of tenancy (unless owner lives on the property). Eviction is in fact only allowed after the first year for a few specific causes including conversion to owner-occupied (either the present owner, their family, or through sale to a new owner who intends to occupy), significant repair or renovation, or change of use. Even in such circumstances, unless the property has four or fewer units, the owner must pay relocation expenses including one month's rent.

The provision that exempts eviction for change of use is concerning given the general effect of many rent control ordinances to incentivize such conversions. However, it seems that the authors of the bill believed that the 7% + CPI cap and other provisions provide enough space to make sure that most properties remain in use as rental housing, though that will remain to be seen.

CONCLUSIONS

Rent control policies are controversial. They create significant winners and losers and raise serious questions about the prioritization of certain segments of society with others and economic concerns with moral ones. With such dynamics, it is a given that there are no easy answers, at least not to those not given to ideological posturing. The fact is that housing is both an economic system and a human one, with very real ramifications for those involved, which just happens to be everyone.

It is true that rent control policies often engender significant inefficiency, both in their substance and their specific application, but economic efficiency cannot be the sole determinant of public policy. It must balance equity with efficiency, and in circumstances where housing, a principal necessity for every person and a dominant budgetary component for most households, is concerned, we must be willing to have hard conversations about how we balance those values.

It is the belief of the author of this report, that while rent control policies are often ill-advised and reflexive (and frequently too tardy to ameliorate the worst scenarios), the authors of SB-608 have given a great deal of consideration to the economic questions inherent in any such policy and have, by and large, addressed them. Whether they are successful will not be known in the immediate future, and it is supremely advisable that the impacts of this legislation are carefully monitored going forward so that it may be altered and adapted as needed to protect renters from the imposition of unconstrained housing price growth without sacrificing the essential functioning of the housing market, on which we all depend.

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