**Rent Destabilization Study II:**
**An Analysis of the Fairness to Landlords of Rent Increases**
**Granted by the Rent Guidelines Board for Stabilized Apartments**

By the Office of Public Advocate Mark Green
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## INTRODUCTION

Last month the Office of the Public Advocate released a study identifying who would be most affected by destabilization of rent in New York City. We found that about 564,000 NYC children are living in rent-regulated housing and that the percentage of renters in stabilized apartments who already pay 40% or more of their income on rent has risen to 37%. The higher rents that would result from rent destabilization could disrupt the lives of these children by forcing their families to move out of their homes and neighborhoods.

We also found that approximately 47% of stabilized apartments are occupied by middle-class people who could move out of NYC if their rents rise to the high levels predicted in the Rent Stabilization Association's own analysis of the impact of deregulation. We concluded that thousands of tenant households -- especially those with two modest income-earners -- could be affected by plans to expand so-called "luxury" decontrol. A good job offer easily could lure these hard-working people away from our City, especially if they would be penalized by unfairly high rents here if their income goes up.

Finally, in light of proposals to allow rent stabilization to lapse when apartments are vacated ("vacancy decontrol"), we examined a study conducted in 1974 which found that when vacancy decontrol was tried in New York City it resulted in exorbitant rents and harassment of tenants -- and failed to promote more housing investment as claimed by its proponents.

This study -- the second in our series -- examines the claim, made by those who attack rent stabilization, that the rent increases allowed for stabilized apartments are unfairly low and make it impossible for landlords to earn a reasonable income. The Office of the Public Advocate obtained the data that the Rent Guidelines Board ("RGB") used as guidance over the past 22 years for granting rent increases to landlords for stabilized apartments. From these figures, the Office calculated the cumulative impact of: (1) the rent increases granted to landlords by the RGB, and (2) the rent increases that would have been expected based on the actual rise in costs for landlords to maintain apartments.

The study concludes that the RGB has nearly always been more generous to landlords than its calculations of increased costs would direct. Moreover, according to Rent Guidelines Board calculations, the rent increases and corresponding income to landlords have kept pace with inflation while data from the Housing and Vacancy Surveys of 1993 and 1996 reveal that tenant income, adjusted for inflation, dropped by 14.6% from 1990 to 1995 while inflation-adjusted rents

rose by more than 8%.

These results demonstrate that NYC's rent stabilization system is meeting the goal of fairness to landlords. Pending proposals to end rent stabilization, including Governor Pataki's recent proposal for so-called "vacancy decontrol," would simply allow landlords to exploit the absence of a competitive market in housing and further reduce affordable housing for tenants.

## BACKGROUND: RENT STABILIZATION IS DESIGNED TO PROMOTE FAIRNESS IN A NONCOMPETITIVE MARKET

The overall rental vacancy rate in NYC currently is 4%, and State law declares a housing emergency when the vacancy rate falls below 5%.[1] The rate for low rent units is lower; for example, the vacancy rate for $400-$499 level apartments is only 3.2%. Because the vacancy rate in the City is so low, landlords do not have to compete aggressively with each other for tenants as, for example, restaurants must compete for customers. While prospective tenants may have the illusion of choice because they can go to many real estate offices and landlords to seek housing, the scarcity of empty apartments -- especially affordable ones -- leaves them little choice and virtually no bargaining power; they essentially have to "take whatever they can get."

Since housing is a necessity, not a luxury -- and since affordable housing is critical to maintain a diverse population and a healthy economy -- some regulation of rents under these conditions is reasonable. Rent stabilization, a system which applies to 52% of all apartments in New York City and 94% of all rent-regulated apartments,[2] was established to serve this purpose.

A well-designed and implemented rent stabilization system should establish rent increases that are fair to both landlords and tenants. The rent increases should allow landlords to recover the costs of improvements that they make to apartments or apartment buildings, to clean and repaint apartments for re-renting when tenants vacate the premises, and to recover the costs of general maintenance and repairs while maintaining a reasonable profit margin. Tenants, on the other hand, should not be forced to pay rents that have been increased simply based on "what the market will bear" -- when there is no competitive market.

## RENT STABILIZATION IS NOT A SUBSIDY

Contrary to common misconceptions, the rent stabilization system does not hold rents at a fixed level, but rather allows landlords reasonable, regular rent increases that appropriately reflect the rising costs of maintaining apartments and afford landlords a reasonable profit margin.[3] Although many people are unaware of this, the rent stabilization system not only allows regular annual increases in rent but also grants landlords special rent increases to cover the costs of improvements that they make to their buildings or individual apartments and allows them a special

[1]Emergency Tenant Protection Act § 8623, Unconsolidated Laws; N.Y.C. Admin. Code § 26-501.

[2]Rent stabilization generally applies to apartments in buildings with six or more units built before February 1, 1947, where the current tenant moved in on or after July 1, 1971, and to apartments in buildings with six or more units built between 1947 and 1973 -- or after 1974 if the units received a 421-a or J-51 conversion tax abatement and the tenant moved in before cooperative or condominium conversion.

[3]It is important to distinguish between rent stabilization and rent control. The more stringent "rent control" system applies to only 3.6% of all rental apartments in the City; the number of these units has dropped by 30% since 1993 and will continue to decline without any government intervention. Most occupants of rent controlled apartments are elderly -- the median age of rent-controlled tenants is 70. As they move on to nursing homes and other special care facilities or pass on, the newly vacant apartments are converted to the rent stabilization system.

rent hike when an apartment is vacated.

The results of this study reveal that rent stabilization cannot properly be characterized as a "subsidy" of tenant rents by landlords. The Rent Guidelines Board ("RGB") has regularly granted landlords rent increases that are as high as -- and probably higher than -- needed to maintain a reasonable profit. While both landlords and tenants have argued over the specific formulas and data that should be used to determine those costs and profit margins over the years, this study finds that, overall, the approach of the current rent stabilization system has successfully created a more fair landlord-tenant relationship in NYC's noncompetitive housing market than would exist without such regulation.

## SPECIFIC RESULTS OF ANALYSIS

One way to assess the fairness of the rent stabilization system is to evaluate the long-term impact of rent increases granted to landlords by the RGB in comparison with inflation and increased costs for maintenance of apartments. The Office of the Public Advocate has compared the standard commensurate rent increase -- the calculation used by the RGB to determine the amount of rent increase that would be required to maintain landlords' current dollar net operating income at a constant level -- with actual rent increases approved by the Board for one- and two-year leases over the past 22 years. See Tables I and II.

These comparisons reveal the following:

- If the RGB had considered only the standard Commensurate Rent Increase formula -- which is designed to maintain landlord income at a constant level -- rents for two-year leases (where the first year ended in an even year) would have risen 96% from 1975-1997. But the RGB instead allowed actual two-year lease rents to increase by 131% during this period -- or 37% higher than indicated by the standard formula.[4] For two-year leases where the first year ended in an odd year, the RGB allowed rents to increase by 127%, or 27% higher than indicated by the standard formula. About seven of every ten leases for rent stabilized apartments are two-year leases.

- Similarly, if the RGB considered only the standard formula, rents for one-year leases would have increased by 143% from 1975 to 1997, but the RGB final decision allowed actual one-year lease rents to increase by 210%

[4]The standard Commensurate Rent Increase for two-year leases is calculated based in part on an estimate of the increase in costs to maintain an apartment. A comparison of the projected Price Index with the Actual Price Index for each year reveals that the RGB estimate has slightly favored the landlords over time; as a result, the increase in rent for two-year leases indicated by the Commensurate Rent Increase formula as necessary to maintain landlord income, compounded over the past 22 years, is 2% to 5% higher than would have been calculated if the Projected Price Index had been equal to the Actual Price Index.

during this period -- or 47% higher than indicated by the standard formula.

- The RGB granted landlords rent increases higher than indicated by the standard formula in 18 of the past 22 years. For two-year leases, 45% of the rent increases granted by RGB over this period exceeded the standard formula's result by two percentage points or more.

This means that if a tenant rented an apartment in 1975 for $400 per month -- or $4,800 per year -- and renewed the lease every year, the cumulative impact of the RGB's decisions would have resulted in rent payments totalling $3,216 more for lease year ending 1997 than indicated by the standard Commensurate Rent Increase formula. If the same tenant had renewed the lease every two years (with the first year of the lease ending on an even year), the cumulative impact of the RGB's decisions would have resulted in rent payments totalling $1,680 more for lease year ending 1997 than indicated by the standard formula, as indicated in the chart below:

**Cumulative Impact of Lease Renewal Over 22 Years on 1997 rent for Apartment that Rented at $400 in 1975**

| | Rent Indicated by Standard Formula (Monthly) | Actual Rent Hike Authorized by RGB (Monthly) | Difference in Monthly Rent | Difference in Annual Rent |
|---|---|---|---|---|
| 1 Yr Lease: | $972 | $1,240 | $268 | $3,216 |
| 2 Yr Lease: | $784 | $924 | $140 | $1,680 |

The above results, moreover, do not take into account any additional rent increases that landlords have obtained for improvements in individual apartments and building improvements. Landlords are entitled to rent increases whenever they replace boilers or elevator systems, renovate apartments, install new appliances or furniture, or conduct other major capital improvements or individual apartment improvements. For building-wide "Major Capital Improvements" ("MCIs") and for improvements in an individual rent-controlled apartment, the landlord must apply to the State Division of Housing and Community Renewal ("DHCR") for approval of a rent increase, but the rules are more lax for rent stabilized apartment improvements. If a rent stabilized apartment is occupied, the tenant must agree to the increase in writing, but if the apartment is vacated, the landlord is not even required to apply to the State DHCR for approval of the rent increase.

The rent increase granted for building or apartment improvements becomes part of the apartment's base rent and thus becomes part of the landlord's income for every subsequent year -- even long after the cost of the improvement itself has been recovered.

The results also do not take into consideration the additional rent increase that is allowed when an apartment is vacated. Fully 39% of rent stabilized apartments turned over within the past three years, and 58% turned over within the past six years. The vacancy allowance has been quite high in some years. It was 12% for leases ending in 1989 and 1990 and 15% in 1982, and usually is at least 5%.[5] Like the increase for building or apartment improvements, the vacancy allowance is *added* to the regular allowable rent increase. It then becomes part of the apartment's base rent and, consequently, part of the landlord's income for every year thereafter.

## THE STANDARD RENT FORMULA IS IMPERFECT BUT SERVES AS A REASONABLE MEASURE OF RGB FAIRNESS TO LANDLORDS OVER TIME

The standard commensurate rent increase calculated by the RGB is the amount of rent increase that the RGB estimates is needed to maintain landlords' current dollar net operating income at a constant level. Because the amount of rent directed to operating costs generally has been at or near 66% in recent years, the RGB calculates that the rent increase should amount to approximately two-thirds of the corresponding increase in operating costs in order to maintain the landlords' income from rentals.[6] (While the standard formula does not consider the impact of inflation on landlords' profits, a formula recently developed by the RGB does take this into account and a recent calculation conducted by the RGB for the period between 1989 and 1995 confirms that landlords' reported income has kept pace with inflation. See discussion below.)

To determine how much landlords generally should be spending to maintain their apartment buildings, the RGB produces a "Price Index of Operating Costs" ("PIOC" or "Price Index"). Like the Consumer Price Index, the RGB's Price Index measures the change in price for a set of goods and services. Rather than measuring the change in consumers' "cost of living," the Price Index describes changes in the costs to operate and maintain rent stabilized buildings. It considers water and sewer rates, real estate taxes, insurance rates, utility costs, contracting prices for plumbers, electricians, painters and other workers, attorney fees, administrative costs and the prices of building and maintenance supplies.

The Commensurate Rent Increase formula may be unfair to tenants for several reasons:

- The RGB reports that in years past the Price Index upon which the Commensurate Rent Increase is based may have overstated actual cost increases, stating, "Expenditures examined in the most recent I&E [Income and Expense] study suggest that from 1989 to 1993 actual costs rose by some 18% while the PIOC indicated a 25% rise

[5]RGB Orders 15, 20 and 21.

[6]The RGB staff's Commensurate Rent Increase calculation for the lease period ending in September 1998, for example, was based on the actual price index for the April to April year ending 1997 and the rent to income ratio derived from landlord reports for 1995.

- perhaps reflecting recession induced cost cutting."[7]

- The Price Index reflects costs that ideally should be incurred by landlords to maintain apartments -- but some of these costs may not in reality be incurred. A landlord may not supply heat at the proper level throughout the heating period, conduct repairs to apartments and conduct repairs to the building itself -- but will get to pocket the money anyway.

- The Price Index is greatly affected by fuel and utility costs; consequently, an aberrational "spike" in such costs in any particular year may unfairly cause a permanent increase in base rents for calculation of future increases.

- As noted above, vacancy allowances and rent increases to accommodate building improvements or individual apartment improvements become part of the base rent and are compounded over the years by the Commensurate Rent Increase formula.

Landlords correctly argue that the standard formula does not consider that as buildings age, owners must make more repairs, so that even if the actual cost of a repair service may not have risen, their use of that service may have increased. The Price Index tracks changes in cost but not changes in frequency of use. Nevertheless, the Price Index is only one of several factors that the Board considers in making a final determination on rent increases; public hearings, independent studies and political considerations also can play a role.

As noted above, during the 22-year period examined by the Public Advocate's Office, the RGB granted landlords a higher one-year and two-year rent increase than indicated by the standard formula in 18 of the past 22 years, or in 82% of its decisions. Moreover, as explained above, landlords are entitled to rent increases based on major capital improvements to their buildings or individual apartment improvements which they undertake, and those increases continue to form part of the base rent for the apartment even after all costs for improvements have been paid.

Landlords argue that the formula is not generous enough to them because it does not consider the mix of one and two year lease renewals -- since about 70% of leases are two-year, the formula does not accurately estimate the amount of income needed to compensate landlords for past operation and maintenance increases. However, it should be noted that the formula does set a two-year lease figure based on a projection of the price index for the subsequent year, and as noted above, that projection has traditionally been more favorable to the landlord than the tenant. Moreover, in 1996, the RGB opted to make use of a "Net Revenue" formula which specifically

[7]RGB Explanatory Statement, Order No. 27, p. 15.

incorporated information on lease terms to set one and two year lease levels.

Landlords also assert that the formula does not consider the erosion in value of landlords' income by inflation -- so that by maintaining current dollar net operating income at a constant level, profitability may decline over time. The RGB points out that such a decline would not necessarily occur, since profit decline depends on the level of inflation, how much income is debt service and how much is profit, changes in tax laws and changes in interest rates.[8] Nevertheless, to address landlord concerns, the RGB recently developed a "NOI [Net Operating Income] formula that not only considers information on lease terms but also takes inflation into account. Even in light of this formula, the RGB still appears to be granting rent increases to landlords that are fair to them.

- For one-year leases ending in 1997 and two year leases ending in 1998, the RGB still granted rent increases higher than even this formula indicated were necessary. The formula indicated that a 4.5% one-year, 6% two-year and 8.5% vacancy increase would maintain landlords' incomes; the RGB decided to allow a 5% one-year, 7% two-year and 9% vacancy increase.

- The "NOI Adjusted Net Revenue" formula inflates the debt service portion of the estimate for net operating income, according to the RGB, since interest rates have been falling rather than rising over recent years.[9]

- Because the "NOI Adjusted Net Revenue" formula addresses two major concerns of the landlords about the standard formula but does nothing whatsoever to address concerns raised by tenants, it is arguably the least fair of the RGB's formulas from the perspective of tenants.

Although this new inflation-adjusted formula has only been used in recent years, a calculation conducted by the RGB for the period between 1989 and 1995 found that landlords' reported income has kept pace with inflation. See Exhibit 1, attached. Renters income, unfortunately, has not. From 1990 to 1995, the median household income of renters, adjusted for inflation, declined by 14.6%.[10]

The Standard Commensurate Rent Increase formula certainly is not perfect -- perhaps no formula will ever be perfect -- but it remains an important component of the rent guidelines

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[8]Rent Guidelines Board, *Housing NYC: Rents, Markets and Trends '96* (1996), p. 38.

[9]RGB, *Housing NYC: Rents, Markets and Trends '96*, p. 38.

[10]Anthony Blackburn, *Housing New York City 1993*, p. 86 (gives the percent change in 1992 dollars from 1990 to 1992). Dept. of Housing Preservation and Development, "Selected Findings of the 1996 New York City Housing and Vacancy Survey" (February 20, 1997), p. 3 (gives the percent change in 1992 dollars from 1992-1995). Owners of houses and condominiums (including those who live in buildings containing apartments that they rent out) fared better than renters, with a more modest decline in inflation-adjusted income of 1.6%. Figures for renters' and owners' income are provided by the New York City Housing and Vacancy Surveys, which are conducted every three years. The resulting reports do not present this data for 1989.

decision-making process and an important measure of the long-term benefits to landlords of rent increases granted by the RGB.

Staff: Suzanne Mattei, Assistant Deputy Advocate, Office of the Public Advocate

**TABLE I**
**Comparison of Standard Commensurate Rent Increase for One Year Lease with Increases Granted by RGB Compounded over 22 Years**

| Lease Year Ending September* | Standard Commensurate Rent Increase (to maintain landlords' net operating income) | Actual Rent Increase Granted by RGB for One-Year Lease** |
|---|---|---|
| 1976 | 4.0% | 7.5% |
| 1977 | 5.5% | 6.5% |
| 1978 | 4.8% | 6.5% |
| 1979 | 0.4% | 4.5% |
| 1980 | 6.6% | 8.5% |
| 1981 | 10.9% | 11.0% |
| 1982 | 9.9% | 10.0% |
| 1983 | 2.0% | 4.0% |
| 1984 | 1.8% | 4.0% |
| 1985 | 4.3% | 6.0% |
| 1986 | 3.7% | 4.0% |
| 1987 | 4.4% | 6.0% |
| 1988 | 1.5% | 3.0% |
| 1989 | 4.2% | 6.0% |
| 1990 | 4.4% | 5.5% |
| 1991 | 7.3% | 4.5% |
| 1992 | 3.8% | 4.0% |
| 1993 | 3.0% | 3.0% |
| 1994 | 3.3% | 3.0% |
| 1995 | 1.4% | 2.0% |
| 1996 | 0% | 2.0% |
| 1997 | 4.0% | 5.0% |
| [Total Increase] (Compounded) | [143%] | [210%] |

* Before the lease year ending September 1981, lease deadlines for the rent stabilization system ended June 30.
** See RGB Explanatory Statements Nos. 7-28 for price indices, calculations of commensurate rent increases and final

determinations of allowable rent increases.

**TABLE II**
**Comparison of Two Year Lease Standard Commensurate Rent Increases (based on Projected and Actual Price Indices) with Increases Granted by RGB Compounded Over 22 Years**

| First Year of Two-Year Lease Ending September* | Standard Commensurate Rent Increase for Two Year Lease (Based on Projected Price Index) | What Standard Commensurate Rent Increase Would Have Been Based on Actual Price Index | Actual Rent Increase Granted by RGB for Two-year Lease (note: rent is uniform over two years)** |
|---|---|---|---|
| 1976 | 7.4% | 6.9% | 9.5% |
| 1977 | 7.7% | 7.8% | 8.0% |
| 1978 | 6.9% | 5.0% | 8.5% |
| 1979 | 2.3% | 3.8% | 6.5% |
| 1980 | 9.4% | 12.5% | 12.0% |
| 1981 | 14.6% | 16.3% | 14.0% |
| 1982 | 13.6% | 11.0% | 13.0% |
| 1983 | 4.1% | 3.0% | 7.0% |
| 1984 | 4.3% | 4.0% | 7.0% |
| 1985 | 6.8% | 6.3% | 9.0% |
| 1986 | 5.7% | 6.1% | 6.5% |
| 1987 | 7.8% | 5.2% | 9.0% |
| 1988 | 3.9% | 3.7% | 6.5% |
| 1989 | 6.5% | 6.6% | 9.0% |
| 1990 | 7.1% | 8.3% | 9.0% |
| 1991 | 9.5% | 9.5% | 7.0% |
| 1992 | 6.1% | 5.3% | 6.5% |
| 1993 | 5.1% | 4.9% | 5.0% |
| 1994 | 4.4% | 4.0% | 5.0% |
| 1995 | 2.6% | 1.5% | 4.0% |
| 1996 | 1.1% | 2.2% | 4.0% |
| 1997 | 5.0% | 4.9% | 7.0% |
| [Total Increase] (Compounded) | [96%] (99.8% odd yrs) | [94%] (95% odd yrs) | [131%] (127% - odd yrs) |

[*] Before the lease year ending September 1981, lease deadlines under the rent stabilization program ended on June 30.
[**] See RGB Explanatory Statements Nos. 7-28 for projected and actual price indices, calculations of commensurate rent increases and final determinations of allowable rent increases.