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THE SHATTERED DREAM OF AMERICAN HOUSING POLICY — THE NEED FOR REFORM†*

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For a quarter century, home ownership has been an integral part of the American dream. A vast subsidy machinery has been built upon the apparently simple premise that every citizen ought to own a home of his or her own. Unfortunately, during the past decade the reality of high interest rates, rising construction costs, and the dismantling of our antiquated, over-regulated banking system has shattered this dream for most Americans.¹ The average house is now too costly for the average American family.² In urban areas in particular, the post-war generation is discovering that it must settle for rental accommodations. In light of these changes, it is crucial to rethink housing policy and evaluate the wisdom of current subsidies.

The rental housing market in the United States exists at the mercy of a number of complex economic and legal institutions. The federal government, through indirect tax subsidies in the form of tax deductions and credits, has an immense impact upon rental housing.³ Furthermore, investment in residential rental property is increasingly viewed merely as one of a large number of possible investment choices, and is therefore subject to capital market forces and competition for investment dollars. State and local governments also exercise substantial influence over residential housing through the vast panoply of legal controls they may impose, such as zoning laws, rent control laws, cooperative and condominium controls, and building codes. All of these measures affect the profitability of rental housing as an investment.⁴

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¹ The notion that homeownership is a basic entitlement of every citizen may be traced back to the political situation immediately following World War II. See generally THE REPORT OF THE PRESIDENT'S COMMISSION ON HOUSING xviii-xxvii (1982) [hereinafter cited as REPORT].

² The average purchase price of a new house in the United States (in a survey of 32 major metropolitan areas) currently is approximately \$94,000. If one assumes that a potential borrower would finance 80 percent of this purchase price, he or she would borrow \$79,200. Assuming a 30 year, fixed-rate mortgage at 13.5 percent, monthly debt service would be approximately \$915. See 18 LAND USE DIGEST, January 15, 1985, at 1-2. The average gross household income in the United States currently is approximately \$24,000 per year or \$2,000 per month. Thus, the debt service on the average house assuming favorable terms (fixed rate mortgage, 30 year amortization) would require thirty-six percent of gross income, a figure, after taxes and insurance are added, that would be prohibitive. See also HOUSING SUPPLY AND AFFORDABILITY 12 (F. Schnidman and J. Silverman eds. 1983) [hereinafter cited as HOUSING SUPPLY AND AFFORDABILITY].

³ Of course, this impact is intended. The tax code is used as a method of subsidizing housing, see *infra* notes 20-51 and accompanying text.

⁴ See *infra* notes 52-185 and accompanying text.

This article will first examine the various ways federal, state, and local laws affect the availability and affordability of residential rental property. Second, this article will suggest that at the present time, federal policies towards residential rental housing, as expressed primarily in the tax laws, are in substantial conflict with state and local policies. This conflict results in economic inefficiency and misallocation of resources in the housing market. Third, this article will suggest that local housing policy has non-local fiscal effects, and that federal programs to alleviate state and local housing problems in some areas often create a subsidy for those areas to the detriment of the residents of the other areas not so highly subsidized. Consequently, all taxpayers must pay for the inefficiency of misdirected local housing policies. Fourth, this article will suggest that because of the increasingly large numbers of Americans who cannot afford to purchase a home and must therefore rely upon the availability of rental housing, and because of the economic and social advantages offered by rental housing as opposed to home ownership, it is necessary to rationalize and make consistent the federal, state, and local measures affecting housing to ensure a continuing supply of affordable and adequate rental housing stock, even at the expense of reducing the supply of owner-occupied housing. Finally, this article will suggest that new federal legislation specifically directed against state and local laws inconsistent with the proposed policy be enacted, that the residential rental housing market be placed in federal rather than state or local control, and that the federal government shift the focus of its subsidies to low and moderate income renters affected by increased rental housing costs.

To have efficient allocation of scarce housing dollars, people should be confronted with the true costs of their housing choices. The subsidy, for instance, to be provided for home ownership by way of tax deductions for home mortgage interest and state and local property taxes for the fiscal years 1984-1989 amounts to \$255.8 billion dollars in uncollected revenue.⁵ Most of the benefit from these tax deductions goes to middle and upper income households.⁶ By reducing or eliminating subsidies for home ownership the choice between owning or renting will be made on the basis of what each individual or family can afford to purchase. While a basis for providing a subsidy to certain low or moderate income renters to ensure at least a minimum level of shelter may exist, little justification exists for using scarce housing dollars to subsidize the acquisition of home ownership equity and living space for people earning more income than fifty percent of other Americans.⁷

⁵ 18 LAND USE DIGEST, January 15, 1985, at 3 (this figure consists of \$185.3 billion for the home mortgage interest deduction and \$70.5 billion for the state and local property tax deduction).

⁶ See CONGRESSIONAL BUDGET OFFICE, THE HOUSING FINANCE SYSTEM AND FEDERAL POLICY: RECENT CHANGES AND OPTIONS FOR THE FUTURE (1983).

In 1981, for example, households with annual incomes between \$20,000 and \$50,000 — forty-one percent of all households — received sixty-three percent of the benefits from the deductibility of mortgage interest and fifty-five percent of the benefits from the deductibility of property tax payments on owner-occupied units. In that same tax year, households with incomes greater than \$50,000 — seven percent of all households — realized twenty-nine percent and thirty-seven percent, respectively, of all the benefits from these provisions.

Id. at 24-25.

⁷ The authors recommend that rental assistance be provided to below average income earners through a voucher program. The voucher program should not subsidize individuals earning more than the average income, and those individuals should likewise receive fewer direct and indirect subsidies from the federal government. For further discussion of the proposed voucher system of

Several basic premises are helpful in understanding the analysis set forth in this article. Under a common definition, the "residential rental housing market" encompasses two classes of participants, renters and landlords. While this market definition is useful for a number of purposes, such as analyzing the relationships between the two groups, another, broader market definition also exists. It can be argued that the residential rental market is actually a sub-market of the total residential housing market, where there are three participants (in addition to governments): renters, landlords, and home owners. The value of this extended market definition is that it is towards this broader residential market that federal, state, and local housing policy is oriented.⁸ Indeed, if one assumes that there is a limited amount of financial aid available for subsidizing all types of housing, one sees that a tension exists not simply between landlords and renters, but among landlords, renters, and homeowners.⁹ It is this tension that government must mediate. As competitors for governmental housing dollars, homeowners must be taken into account for purposes of this analysis in any policy decision about rental housing.

This article's approach to the problem of rental housing is also premised on the belief that, from the investment standpoint, there is nothing special about rental housing, so that the decision to invest in rental housing will be based principally upon an analysis of potential risk and return.¹⁰ A rational individual with a specified amount to invest will choose from among available options the investment that maximizes return and minimizes risk. A rational investor will invest in residential housing if and only if it is the best investment available to him or her. Factors such as the availability of tax benefits will only be significant with respect to their impact upon bottom-line yield and the risk of not receiving such a yield.¹¹ Thus, for instance, if as a result of governmental regulation the return on an investment in residential rental property is less than the return on municipal bonds, and the risks inherent in the two investments are comparable, the rational investor will choose municipal bonds.¹² The effects of governmental regulation on the viability of residential rental property as an investment are, therefore, of major significance, and the maintenance of an adequate supply of privately owned residential rental property will be directly dependent upon such regulation. This proposition, of course, is neither new nor radical, but it is too often forgotten today by commentators and by legislators.

I. RENTAL HOUSING VS. HOME OWNERSHIP

The current trends in home ownership costs show that the average home is no longer affordable to the average home buyer and the gap between the two is not expected to

subscribers, see *infra* notes 173-79 and accompanying text. See *infra* notes 20-51 and accompanying text for a discussion of federal subsidies and notes 186-87 and accompanying text for a discussion of federal tax changes.

⁸ On the one hand, it is possible to differentiate the rental market from the owner-occupied market with some overlap. Viewed broadly, however, both would-be renters and homeowners are seeking housing, and politically, both renters and homeowners can often be treated simply as "consumers of housing."

⁹ A basic assumption of this article is that potential subsidy funds are limited. See *infra* notes 173-87 and accompanying text. See generally HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 11-28.

¹⁰ Generally, risk bears a direct relationship to return in a rational market; the higher the risk required, the higher the return demanded by the investor.

¹¹ All factors influencing return and risk can be quantified and used to "discount" potential return. Thus every investment may be analyzed in terms of an expected bottom-line return.

¹² Irrational investment decisions are ignored here, but it is acknowledged that some investors will choose a particular asset on unique and subjective bases, that is, they "like" real estate and, thus, derive a portion of their investment return in the form of non-monetary, personal satisfaction.

diminish.¹³ The substantial disparity between the average American's income and the cost of the average home brings into question the wisdom of continued mass subsidies to support home ownership at a time of record federal deficits and high interest rates.

Several reasons make favoring rental housing over home ownership reasonable.¹⁴ In contrast to the typical single family residential home ownership unit, the average rental housing unit, as part of a multi-unit structure, can be built with higher density use of land, which in many urban areas is a significant cost factor in determining housing affordability.¹⁵ Additionally, a probable basis exists for assuming that household expectations are significantly different for home ownership as opposed to renting. The standard by which many people judge home ownership is by the suburban one or two story home on an individual lot with multiple bedrooms, family rooms, garage, and more than one bathroom.¹⁶ Cost considerations are slowly reducing these expectations but the dream continues for many home buyers.¹⁷ In contrast, the image associated with rental housing tends to be of a housing unit with fewer rooms and less total square footage.¹⁸ Thus, the

¹³ For further discussion see *supra* notes 1-12 and accompanying text. See also HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 11-28.

¹⁴ There is general debate over the superiority of home ownership to renting. Some argue that actual home ownership as opposed to renting is the most rewarding form of tenure and that it fosters better personal maintenance of the nation's housing stock. See M. FRIEDMAN & R. FRIEDMAN, FREE TO CHOOSE 110-11 (1980) [hereinafter cited as M. FRIEDMAN & R. FRIEDMAN]; J. KEMENY, THE MYTH OF HOME OWNERSHIP — Private Versus Public Choices in Housing Tenure 11 (1981) (referring to government publications from the United Kingdom, the United States, and Australia) [hereinafter cited as J. KEMENY]. On the other hand, others believe such a view is merely the product of a sociological bias towards home ownership reflected in economic and political arrangements designed to encourage owning in English speaking countries such as the United States, England, and Australia. See *id.* at 1-18. Also to be considered in this debate are historical indications favoring the efficiency and innovative potential of rental housing in the implementation of new technology and design due to shared facilities and higher density land-use. See G. WRIGHT, BUILDING THE DREAM — A Social History of Housing in America 135-51 (1981) [hereinafter cited as G. WRIGHT]. Furthermore, an argument can be made that as people take longer tenure in rental housing and begin to view it as long-term housing, they will have increased incentive to take care of their housing units.

¹⁵ Housing costs today are leading to reduced consumer expectations and attempts to increase housing density by various methods such as increased renting of space in owner occupied homes, infill construction, and reduced zoning restrictions. See *Rethinking Single-Family Zoning*, in HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 195-98; *Evaluating Inclusionary Housing Programs*, in HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 199-201; *Housing Conversion: A Strategy In Increasing the Housing Supply*, in HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 213-16; *Shared Housing*, in HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 225-28.

¹⁶ See generally HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 22-24. New homes are getting bigger — the medium priced new home increased from 1,495 square feet in 1965 to 1,645 square feet in 1979, an increase of 10 percent. *Id.* at 22. See also U.S. GEN. ACCOUNTING OFFICE, RENTAL HOUSING: A NATIONAL PROBLEM THAT NEEDS IMMEDIATE ATTENTION 8 (1979) (preference of second and third-time buyers is for larger homes with many amenities) [hereinafter cited as U.S. GEN. ACCOUNTING OFFICE, RENTAL HOUSING].

¹⁷ See Gottschalk, *Trendy Dwellings — The "Affordable" Home Turns Out to Be Tiny and Not Really Cheap*, Wall St. J., Dec. 7, 1983, at 1, col. 1 (High housing costs, especially in expensive urban areas, are making developers build smaller units so that ownership will be affordable to the vast market of first-time buyers. Use of sky lights, mirrored walls, elimination of hallways, and scaling down of appliance sizes are techniques used to give a feeling of "open space" and create an illusion of more housing space while square footage and total costs are reduced.).

¹⁸ See generally G. WRIGHT, *supra* note 14, at 142-44 (The historic development of urban apartments brought about complaints over too little space, especially in the less expensive buildings. The authors believe that these concerns are still on the minds of many consumers.).

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expectations of renters might be more easily met than those of homeowners. These factors have at least an arguable impact on the choice of favoring rental housing over home ownership.

In a more substantive sense at least two significant differences exist between rental housing and home ownership that lead to the conclusion that, as a matter of national policy, rental housing should be favored. First, the access costs to rental housing are significantly lower than those associated with home ownership. The average renter may pay one month's rent and a security deposit to gain possession of a rental unit. For home ownership, the home buyer is generally required to pay 5 percent to 20 percent of the equity value of the property, in addition to substantial closing costs to acquire possession.¹⁹ Second, rental housing is cheaper than ownership of a comparable home because the renter is purchasing less than the home buyer. The home buyer purchases a fee simple interest in the real property while the renter purchases a limited leasehold estate, which leaves a valuable asset still in the hands of the landlord-owner. The landlord's fee ownership interest in the rental housing is a valuable right that can be sold to other investors, mortgaged, or used as collateral for other investments. Furthermore, any appreciation in the property will accrue to the benefit of the landlord, not the tenant. Since the landlord retains these valuable interests with rental housing, the rental of equivalent housing units with equivalent per unit construction costs should be lower than the monthly payment needed for home ownership, in the absence of a subsidy.

Hand owner gets this, too

II. FEDERAL SUBSIDIES

The federal government is the major source of subsidy funds to the residential housing market.²⁰ Two types of subsidy to housing are provided by the federal government. The first type is a direct or cash subsidy. A direct subsidy involves an actual expenditure by the federal government for a specified type of property development or to a specified target group of housing users. Generally, direct federal subsidies for housing have been targeted at two primary groups — low-income families and the elderly. During the past decade, there have been a number of different direct federal subsidy programs. Some have involved direct cash supplementation of housing finance costs, others have involved direct cash payments to cover a portion of fair market rental costs. Perhaps the most successful direct subsidy programs have been the Veterans Administration (VA) and Federal Housing Administration (FHA) mortgage insurance programs, where government agencies encourage lending to home buyers at affordable rates by providing mortgage insurance to lenders.²¹ Some programs have provided subsidies primarily for owner-occupied housing,²² while others have provided subsidies for residential rental housing.²³

¹⁹ The home buyer will have to put down varying degrees of equity depending on the type of financing selected. A Federal Housing Administration insured loan may allow up to ninety-five percent financing so that only five percent equity is required by the buyer, where a conventional loan may only allow eighty percent financing and require twenty percent equity by the buyer.

²⁰ Some states and localities provide cash subsidies for certain types of housing. Compared to the size and scope of federal subsidies, however, these subsidies are de minimus.

²¹ See REPORT, *supra* note 1, at 157-66.

²² The mortgage interest subsidy provided in section 235 of the National Housing Act, 12 U.S.C. § 1715z (1982), is an example of such a program.

²³ The rental subsidies provided in sections 221(d)(3) and 221(d)(4) of the National Housing Act, 12 U.S.C. §§ 17151(d)(3), (d)(4) (1982), are examples of such programs. See generally B. JACOBS, K. HARNEY, C. EDSON AND B. LANE, GUIDE TO FEDERAL HOUSING PROGRAMS (1982).

While federal direct cash subsidy programs have played an important role in the housing market for the past several decades, their scope and impact has been far less than the scope of indirect subsidies in the form of tax benefits for real property ownership. By far the greatest of these subsidies is the deduction allowed for mortgage interest pursuant to Internal Revenue Code ("Code") section 163, allowed both to residential and commercial owners.²⁴ Also of great importance and wide scope is the allowance of depreciation pursuant to section 168 of the Code to commercial owners.²⁵ Indeed, the combination of the interest deduction and depreciation deduction has made ownership of rental property virtually synonymous with tax shelter.²⁶

In addition to these measures, a number of other tax provisions provide substantial incentives for residential property ownership, both rental and owner-occupied. These measures range from tax credits available to homeowners to make their houses energy efficient,²⁷ to credits for rehabilitation of older buildings and historic structures,²⁸ to tax exemptions allowed for interest paid on mortgage subsidy bonds.²⁹ In addition, the exemption of real property from the at-risk rules of Code section 465 also provides a substantial incentive for choosing real estate as an investment medium.³⁰

The various tax subsidies for real estate included in the Internal Revenue Code are targeted to different taxpayer groups and to different types of transactions. An examination of several of the most important subsidy provisions makes this pattern clear. First, consider depreciation under Code section 167 and cost recovery deductions under Code section 168. In general, section 167 distinguishes between property first placed in service by the taxpayer ("new property") and property owned by a taxpayer placed in service by a previous owner ("used property").³¹ Second, section 167 distinguishes between residential rental property and commercial-industrial property.³² Generally, new residential rental property is favored under section 167. This type of property may be depreciated using the most accelerated methods permissible: sum-of-the-years digits method or double declining balance method.³³ The next most favored is new commercial-industrial property, followed by used residential rental property, followed finally by used commercial-industrial property.³⁴ Code section 168, applicable to most property placed in service after 1981, eliminates the significance of the distinction between new and used property, but retains the distinction between residential rental property and commercial-industrial property.³⁵ Under section 168 all real property used in a trade or business may be depreciated using either the straight-line method or a schedule based upon the 175% declining balance method.³⁶ Section 168 itself does not distinguish between residential

²⁴ See I.R.C. § 163 (1982) (mortgage interest deduction).

²⁵ See I.R.C. §§ 167, 168 (1982) (depreciation and cost recovery deduction).

²⁶ In this article tax shelter is used to refer to an investment yielding such a significant return in the form of tax benefits to the extent that the tax benefits are a principal motivation for investment. See R. WESTIN, LEXICON OF TAX TERMINOLOGY 764-65 (1984).

²⁷ I.R.C. § 44C (1982) (energy tax credit).

²⁸ I.R.C. § 48(a)(1)(E) (1982) (rehabilitation credit).

²⁹ I.R.C. § 103A (1982) (mortgage subsidy bonds).

³⁰ See I.R.C. § 465 (1982) (at-risk rules).

³¹ I.R.C. § 167(j)(1), (5) (1982).

³² I.R.C. § 167(j)(2) (1982).

³³ *Id.*

³⁴ See I.R.C. § 167(j)(1), (4), (5) (1982).

³⁵ Of course, the old section 167 distinctions are still applicable to property not subject to I.R.C. § 168.

³⁶ I.R.C. § 168(b)(2) (1982).

property and commercial-industrial property. This distinction, however, is of the utmost significance regarding the recapture of sale proceeds and recharacterization of such proceeds as ordinary income pursuant to Code sections 1245 and 1250. Prior to 1981 all real property depreciated under section 167 was subject to the recapture rules of section 1250, so that the excess of cumulative accelerated depreciation over what straight-line depreciation would have been at the time of sale was recaptured as ordinary income.³⁷ This treatment was more favorable than the treatment accorded tangible personal property under section 1245. The full amount of any depreciation allowed on such tangible personal property under section 1245 was recaptured as ordinary income.³⁸ The Economic Recovery Tax Act of 1981 (ERTA) modified these rules and reclassified commercial-industrial property depreciated by an accelerated method as section 1245 recovery property subject to full recapture of all depreciation.³⁹ Residential rental property remains section 1250 property subject only to recapture of excess accelerated depreciation.⁴⁰ Thus, under the rules of sections 167 and 168, a hierarchy of subsidies has been established in which residential rental property is most favored.

Whereas the Code provisions relating to depreciation and cost recovery deductions are targeted at specific types of property, the deductions for interest and certain taxes permitted under Code sections 163 and 164, respectively, are not so targeted.⁴¹ Indeed, while owners of residential rental property are permitted to use such deductions, a large proportion of revenue lost as a result of section 163 is lost to owners of single-family homes. In effect, the section 163 interest deduction is a massive subsidy for homeowners.⁴²

Generally, neither the depreciation nor interest deductibility provisions of the Code are targeted at specific economic classes of individuals. This lack of close control is characteristic also of most of the other significant subsidy provisions contained in the Code.⁴³ For instance, the exemption from the at-risk rules for real property under section 465 applies to all real property, other than mineral property, used in a trade or business or held for investment, regardless of the particular use or the character of the user. Similarly, such benefits as the tax credits provided for solar energy equipment, for rehabilitation of older structures, and for preservation and rehabilitation of historic structures are all geared to types of property or transactions with no restrictions regarding the income or economic status of the owners or users.

In fact, only two groups are targeted by a number of tax subsidy provisions for real estate — the elderly and low-income families. For instance, residential rental property occupied by qualifying low-income tenants may be depreciated using the double declining balance method under section 168 rather than the 175% declining balance method.⁴⁴ Another example of a special, targeted tax subsidy is permitting five-year depreciation of the costs of rehabilitating structures occupied by qualifying low-income families.⁴⁵ These

³⁷ See I.R.C. § 1250(b)(1) (1982) (recapture of accelerated depreciation on real property).

³⁸ I.R.C. § 1245(a)(1) (1982) (recapture of accelerated depreciation on personal property).

³⁹ I.R.C. § 1245(a)(3) (1982).

⁴⁰ I.R.C. § 1245(a)(5)(A) (1982).

⁴¹ See I.R.C. §§ 163, 164 (1982).

⁴² See Hellmuty, *Homeowner Preferences*, in *COMPREHENSIVE INCOME TAXATION* 163-72 (J. Pechman ed. 1977).

⁴³ Of course, the deduction is also available to non-homeowners since section 163 of the Code permits the deductibility of all interest subject to the limitations of sections 163(d) and 265.

⁴⁴ I.R.C. § 168(b)(2)(A)(ii) (1982).

⁴⁵ I.R.C. § 167(K) (1982).

targeted subsidy provisions, however, are relatively few in number, are limited exclusively to low-income and elderly individuals, and are limited in value. The major subsidies, such as depreciation and interest deductibility, as noted, are available to taxpayers who enter into specific transactions or conduct certain activities, regardless of their socio-economic group.

If the structure of federal tax subsidies to real estate is viewed from a macroeconomic perspective, a number of points become clear. Federal tax structure is basically a system for reallocating wealth among the tax-paying public. The federal government acts as a clearing-house for collecting revenue and a decisionmaking body regarding how collected revenues will be allocated among competing interests. In the real estate area, as well as other areas, the incentives provided by the federal government through tax subsidies have major economic impact. In the housing market, because they affect the cost of different transactions differently (that is, rental versus residential), the subsidies determine in part where investment capital will flow.

The use of tax subsidies for real estate may be criticized on a number of grounds. One possible ground is allocative inefficiency. The Congressional Budget Office (CBO) conducted a study in 1977 to determine the extent to which so-called "tax shelter" subsidies — depreciation and deductibility of interest — were the most efficient means of subsidizing selected types of income-producing real estate.⁴⁶ The CBO study found that indirect tax subsidies are a highly inefficient mechanism precisely because a great proportion of the subsidy does not benefit real property and its users, but rather benefits syndicators, contractors, and other intermediaries.⁴⁷ The study concluded that if the purpose of tax subsidies is to provide incentives for construction or maintenance of various types of property to ensure a continuing supply of adequate and affordable real estate, direct grants would be far more effective than the use of indirect tax subsidies as an allocation device.⁴⁸

A second criticism that can be leveled at the existing federal tax subsidy structure is that it does not effectively further the policies underlying it. As noted above, with the exception of lower income and elderly individuals, no special group of users of real property is directly the focus of any major tax subsidy provision.⁴⁹ Interest deductions are available to all homeowners, regardless of annual income. High income individuals benefit from the section 163 deduction as do moderate income individuals. Similarly, the owner of conventional residential real estate designed for high income renters can use exactly the same depreciation schedule as the owner of residential rental property designed for a non-subsidized moderate income group.

Also troubling is the vulnerability of the federal tax subsidy to compromise by state or local regulation. Any owner of qualifying property can, for instance, take advantage of the section 168 cost recovery deduction. The economic benefits provided by this tax subsidy, however, can still be taken away from that owner by state or local regulation. For instance, a developer of residential rental property may benefit from an increased depreciation allowance, only to have that benefit offset by a local rent control ordinance. In effect, a state or local government, knowing that an owner of property will not only receive an economic return in the form of rent, but also an additional return from

⁴⁶ CONGRESSIONAL BUDGET OFFICE, REAL ESTATE TAX SHELTER SUBSIDIES AND DIRECT SUBSIDY ALTERNATIVES (1977).

⁴⁷ *Id.* at 2-11.

⁴⁸ *Id.* at 59-93.

⁴⁹ Other uses of real estate which are considered separately for tax purposes, such as for extraction of minerals, are not considered in this article. See, e.g., I.R.C. § 465 (1982).

federally provided tax benefits, may decide to shift some of that composite income away from the landlord to renters simply by artificially limiting rents.⁵⁰ Nothing in the federal tax subsidy system as it presently exists ensures that the broadly defined target groups receive the full benefits of the subsidy provided for them by the federal government. State and local governments, through regulation, can simply reallocate the effects of all or a portion of the federal subsidy to target groups of their own choosing — groups the federal government may well *not want* to aid.⁵¹

Thus, the current system of tax subsidies provided for real estate, in general, and the housing market, in particular, have a number of troublesome aspects. To a great extent the subsidies are not targeted at specific income groups, thereby allowing the wealthy to use federal aid as much as, or more than, lower or middle-income individuals. Second, these subsidies may well be less efficient in terms of the percentage of each subsidy actually put into use in the intended activity than other alternatives. Third, these federal subsidies may be reduced or eliminated by non-federal regulation, thereby permitting state and local governments to usurp federal decisionmaking power as to these subsidy funds.

III. STATE POLICY TOWARDS RESIDENTIAL RENTAL PROPERTY

In addition to federal law, substantial legal considerations at the state level can lead to problems in housing. In general, the implementation of state and local housing policy has created disincentives for investment in residential rental property. Various state judicial decisions and legislative initiatives have reduced the profitability and flexibility of residential rental property ownership. This section of the article will examine specific areas of state intervention that have affected investment in the increasingly important rental housing market. In particular, rent regulation, regulation of the landlord-tenant relationship, regulation of conversions of housing from rental to ownership form, and the impact of restrictive land use and development requirements will be analyzed.

A. Rent Regulation

The impact of rent regulations on construction and maintenance of rental housing, and the secondary effects on home ownership, are of great importance to the formulation of any national policy on housing. Residential property rents have not kept pace with inflation and 'real' rents have actually fallen over the past twenty years.⁵² Inducing investment in the rental housing market, therefore, will require a real increase in rents.⁵³ In the short run, rent regulations that prevent or hinder the necessary rent increases may appear beneficial to tenants already occupying rental housing, but in the long run such

⁵⁰ Put differently, regulation such as rent control may be viewed as tantamount to a tax imposed by the state or local government enabling it to allocate these revenues to its own targeted groups.

⁵¹ At the very least, uneven regulatory policies may create geographic-based allocations not envisaged by the federal government; see *infra* notes 163-65 and accompanying text.

⁵² THE REPORT OF THE PRESIDENT'S COMMISSION ON HOUSING 90 (1982) (real rents down 8.8 percent in the past 20 years).

⁵³ See REPORT, *supra* note 1, at 90; A. DOWNS, RENTAL HOUSING IN THE 1980s 3-4 (1983) [hereinafter cited as A. DOWNS]. Real rents fell about 8.4 percent from 1960 to 1980, or roughly 4.2 percent each decade. Additionally, the real value of rental housing properties in the United States sustainable from rents alone appears to have fallen fifty percent since 1960. *Id.* at 4. This drop in value results from much faster increases in operating costs and interest rates than in rents. *Id.*

regulations are detrimental to everyone because they reduce the number of available units.⁵⁴

The increasing inability of Americans to afford home ownership will add to the demand for rental housing in the 1980's and beyond.⁵⁵ As is the case with most market changes, such increased demand or need for rental housing will not be met by an immediate increase in the rental housing stock. Rather, competitive forces in the housing market should signal the need for more rental housing to investors and bring more investment dollars into this sector of the market.⁵⁶ Even under the best circumstances, however, financing, development approval, and construction time will temporarily leave the rental housing market in disequilibrium and produce short-term "shortages" or pressures on the existing rental stock. Compounding these natural market adjustment time problems are regulations and restrictions that add to the cost of construction and that reduce the profitability of rental housing ownership relative to other investment alternatives. In responding to the increased needs of the rental housing market, investors and developers will be concerned with the rate of return, measured by projected rental income flow, available from their investment in this somewhat risky market.

The President's Commission on Housing has determined that rent regulations can have a deleterious impact on the condition of the nation's rental housing stock.⁵⁷ Rent regulations adversely affect an investor's potential return on rental housing investments and can lead to avoidance of or disinvestment from residential rental property if regulated rent levels are set below the rate necessary to compensate for the time, value, and risk of investment.⁵⁸ The Commission found that rent regulations caused a reduction in the quality of existing rental housing, discouraged new investment in rental housing, and in extreme cases could lead to the abandonment of rental housing.⁵⁹

⁵⁴ See REPORT, *supra* note 1, at 90-94; A. DOWNS, *supra* note 53, at vii, 3 (discussing the importance of profitability); Rabin, *The Revolution in Residential Landlord-Tenant Law: Causes and Consequences*, 69 CORNELL L. REV. 517, 555 (1984) [hereinafter cited as Rabin].

⁵⁵ A. DOWNS, *supra* note 53, at vii, 1-3. In 1980 there were 28.6 million rental units in the United States, constituting one third of all households. *Id.* at 2. Eight out of nine such units were provided by private owners for profit with about sixty percent of the units in structures of fewer than five units. A third of the latter were single-family homes. *Id.*

⁵⁶ See generally Olsen, *Competitive Theory of the Housing Market*, in HOUSING URBAN AMERICA 234-44 (J. Pynoos, R. Schafer, and C. Hartman eds. 1980) (discussing market forces at work as they affect housing).

⁵⁷ See REPORT, *supra* note 1, at 91-92.

⁵⁸ See *id.*

⁵⁹ See *id.* (abandonment is likely where operation as rental property is seen as unprofitable and the landlord is prevented from converting the units to either condominiums or cooperatives). See, e.g., Guenther, *Landlord's Unusual Response to Rent Control Stirs Fight*, Wall St. J., Mar. 21, 1984, at 31, col. 1 [hereinafter cited as Guenther, *Landlord's Unusual Response*]. This article discussed a landlord who, as a result of the Santa Monica, California rent restrictions sought to demolish his building to sell the vacant land, which could be used for other purposes than rental housing because as vacant land the property is worth more than as rental property under the rent control regulations. Santa Monica, in turn, is seeking to prevent the demolition of the building so that it would remain rental housing. See also REPORT, *supra* note 1, at 92 (rent regulations amount to a redistribution of income from landlords to tenants akin to a tax, and operate in an inefficient and inequitable manner; this "tax" imposed by rent control will encourage landlords not to invest in rental housing while encouraging tenants to seek out below-market rents; Muth, *Redistribution of Income Through Regulations in Housing*, 32 EMORY L.J. 691, 693-98 (1983) (discussion of rent control and redistribution of income). For expanded symposium discussion on rent control, see generally 32 EMORY L.J. 690-819 (1983)).

To assess the impact of rent regulations on the supply of rental housing, one must examine the current status of rent regulations and their effect on private investment. Currently, at least 200 cities, seven states, and the District of Columbia have rent control or rent stabilization regulations.⁶⁰ In addition to state control of rents, Congress has on several occasions concerned itself with rent controls for limited periods in response to national emergencies.⁶¹ Originally, governmental authority for rent control was based on a finding by the legislature of an emergency situation that affected or would affect the supply of rental housing.⁶² Today this requirement of an emergency situation as justification for exercise of the police power is no longer required.⁶³ Rent controls can be upheld as long as they bear a real and substantial relationship to the public health, morals, safety, and welfare and as long as the legislature has not acted arbitrarily in implementing the controls.⁶⁴

⁶⁰ REPORT, *supra* note 1, at 91 (over 200 cities have rent regulations). The seven states that have rent control or stabilization regulations are: California, *see, e.g.*, *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 550 P.2d 1001, 130 Cal. Rptr. 465 (1976); Connecticut, *see* CONN. GEN. STAT. ANN. §§ 7-148b-148f (West Supp. 1984); Florida, *see* FLA. STAT. ANN. §§ 125.0103, 166.043 (West Supp. 1984) (for Florida cases dealing with the rent control issue, *see* *City of Miami Beach v. Frankel*, 363 So. 2d 555 (Fla. 1978); *City of Miami Beach v. Forte Towers, Inc.*, 305 So. 2d 764 (Fla. 1974); *City of Miami Beach v. Fleetwood Hotel, Inc.*, 261 So. 2d 801 (Fla. (1972)); Maine, *see* ME. REV. STAT. ANN. tit. 30, §§ 5371-5376 (1964 & Supp. 1984); Massachusetts, *see* MASS. GEN. LAWS ANN. ch. 40 app., §§ 1-1 to -14 (West Supp. 1984-85); New Jersey, *see* N.J. STAT. ANN. § 2A:42-77 (West Supp. 1984-85); New York, *see* N.Y. UNCONSOL. LAWS §§ 5881-8597 (McKinney 1974 & Supp. 1984-85). Rent control has also been adopted by the District of Columbia, *see* D.C. CODE ANN. §§ 45-1601 to 45-1663 (1981 & Supp. 1984). *Cf.* ARIZ. REV. STAT. ANN. § 33-1329 (Supp. 1984-85) (making the issue one of state rather than local control). Alaska and Maryland previously had rent control legislation in effect, though not in current statutes. For discussion of these provisions, *see* *Public Safety Employees Ass'n v. State*, 658 P.2d 769 (Alaska 1983); *Westchester West No. 2 Ltd. Partnership v. Montgomery County*, 276 Md. 448, 348 A.2d 856 (1975).

⁶¹ *See, e.g.*, *United States v. Moore*, 340 U.S. 616, 618-21 (1951) (discussion of National Energy Price Control Acts of 1942 and 1947); *United States v. Wittek*, 337 U.S. 346, 364-65 (1949) (discussion of National Energy Price Control Act of 1942); *Woods v. Hills*, 334 U.S. 210, 211-14 (1948) (discussion of National Energy Price Control Act of 1942); *Bowles v. Willingham*, 321 U.S. 503, 505-07 (1944) (National Energy Price Control Act of 1942); *Block v. Hirsh*, 256 U.S. 135 (1921) (controls for housing emergency resulting from effect of World War I). *See also* Rabin, *supra* note 54, at 555 (discussing rent control and federal government imposition of wage and price controls, which included rents from August 15, 1971 to January 12, 1973). *See also* M. LETT, RENT CONTROL: CONCEPTS, REALITIES, AND MECHANISMS 1-10 (1976).

⁶² *See* *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 135, 550 P.2d 1001, 1006, 130 Cal. Rptr. 465, 470 (1976); *Westchester West No. 2 Ltd. Partnership v. Montgomery County*, 276 Md. 448, 456-63, 348 A.2d 856, 861-65 (1975); *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 555-62, 350 A.2d 1, 7-10 (1975); *Brunetti v. Borough of New Milford*, 68 N.J. 576, 591-94, 350 A.2d 19, 27-28 (1975). *See also* *Kennedy Bros., Inc. v. Sinclair*, 287 F. 972, 977-78 (D.C. Cir. 1923) (rent control is a legislative decision and the judiciary ought not to interfere with its decision). *Contra* *City of Miami Beach v. Fleetwood Hotel, Inc.*, 261 So. 2d 801, 804 (Fla. 1972).

⁶³ *See* *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 135, 550 P.2d 1001, 1006, 130 Cal. Rptr. 465, 470 (1976); *Westchester West No. 2 Ltd. Partnership v. Montgomery County*, 276 Md. 448, 456-63, 348 A.2d 856, 861-65 (1975); *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 555-62, 350 A.2d 1, 7-10 (1975); *Brunetti v. Borough of New Milford*, 68 N.J. 576, 592-94, 350 A.2d 19, 27-28 (1975). *Contra* *City of Miami Beach v. Fleetwood Hotel, Inc.*, 261 So. 2d 801, 804-05 (Fla. 1972). *See generally* *Kennedy Bros. Inc. v. Sinclair*, 287 F. 972, 977-78 (D.C. Cir. 1923).

⁶⁴ *Westchester West No. 2 Ltd. Partnership v. Montgomery County*, 276 Md. 448, 454-55, 348 A.2d 856, 860 (1975). *See also* *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 563-64, 350 A.2d 1, 12 (1975).

Rent regulations can take different forms, but they generally have a common purpose of protecting tenants from "unfair" and dramatic rent increases while purporting to provide landlords with a "fair" return on their investment. Determining the landlord's fair return requires an initial valuation to establish a base rent from which periodic rent adjustments can be made. The method of rental housing valuation therefore becomes important.⁶⁵ Different methods of valuation can lead experts to different conclusions and therefore a detailed explanation of such methods is necessary to evaluate the reasonableness of the independent determinations reached.⁶⁶ Once the legislature has determined the method of valuation to be used for implementing rent regulations, the burden is on the landlord to show that the method selected is improper.⁶⁷ The legislative determination of valuation method will be upheld even if it is the least favorable method for the landlord and even if it results in rent levels significantly below the market rent.⁶⁸

For constitutional purposes, rent regulations are treated like other types of governmental price regulation,⁶⁹ even though the law traditionally has treated real property differently from other areas of commercial endeavor.⁷⁰ As long as permissible rent levels do not amount to confiscation, they are legally supportable.⁷¹ Although a landlord cannot be forced to subsidize his tenants to meet social or economic goals, the fairness of rents need not be judged by their impact on profit or loss of individual landlords provided they are not set at a rate that would be confiscatory to an efficient landlord.⁷² In setting rent

⁶⁵ See generally Malloy, *Lender Liability For Negligent Real Estate Appraisals*, 1984 U. ILL. L. REV. 53, 55-58 (discussion of appraisal methods and footnotes to other sources on methods of real estate appraisal and valuation).

⁶⁶ See, e.g., *Kennedy Bros., Inc. v. Sinclair*, 287 F. 972, 973-77 (D.C. Cir. 1923) (different experts arrived at different determinations of value for the property and the owner's investment).

⁶⁷ See, e.g., *Hartley Holding Corp. v. Gabel*, 13 N.Y.2d 306, 308-09, 196 N.E.2d 537, 537-38, 247 N.Y.S.2d 97, 98-99 (1963) (New York City allowed landlords less than six percent return on their property and used a 1954 property valuation and equalization rate despite the availability of a 1961 equalization figure). See also *Benson Realty Corp. v. Beame*, 50 N.Y.2d 994, 995-96, 409 N.E.2d 948, 949, 431 N.Y.S.2d 475, 476-77 (1980), *appeal dismissed*, 449 U.S. 1119 (1981) (even maladministration or nonadministration does not serve as a basis for declaring such regulations unconstitutional). See generally Guenther, *Landlord's Unusual Response*, *supra* note 59, at 31, col. 1. (some cities, like Santa Monica, California, do not allow a buyer of already rent controlled residential rental property to have rent adjustments reflecting the new owner's purchase price or debt).

⁶⁸ See, e.g., *Kennedy Bros., Inc. v. Sinclair*, 287 F. 972, 977-78 (D.C. Cir. 1923); *Zussman v. Rent Control Bd. of Brookline*, 371 Mass. 632, 637-39, 359 N.E.2d 29, 32-33 (1976). See generally *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 155-56, 550 P.2d 1001, 1020-21, 130 Cal. Rptr. 465, 484-85 (1976).

⁶⁹ *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 157, 550 P.2d 1001, 1021, 130 Cal. Rptr. 465, 485 (1976); see also *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 556, 350 A.2d 1, 7 (1975).

⁷⁰ *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 556, 350 A.2d 1, 7 (1975). "The renting of residential property is as much an essential enterprise as the retail sale of food-stuffs, the extraction and processing of natural resources, the operation of a railroad, or the conduct of a banking business and equally subject to public regulation when the need arises." *Id.* (citations omitted).

⁷¹ *Id.* at 571, 350 A.2d at 16; *Kennedy Bros., Inc. v. Sinclair*, 287 F. 972, 977-78 (D.C. Cir. 1923).

⁷² *Troy Hills Village v. Township Council of Parsippany-Troy Hills*, 68 N.J. 604, 620, 350 A.2d 34, 42 (1975); *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 569, 350 A.2d 1, 15 (1975). In *Troy Hills Village* the court stated:

[t]he test for confiscation is whether the ordinance permits an efficient landlord to obtain a "just and reasonable" return on his property . . . [F]rom a procedural point of

levels that are not confiscatory for the efficient landlord, an individual landlord's actual purchase price and financing costs are not determinative, since the rent setting authority may classify him or her as inefficient.⁷³ Unlike public utility rate regulation, rent control is not concerned with balancing competing interests and establishing the best rent level.⁷⁴ To the contrary, rent control generally involves establishment of the lowest rent level constitutionally permissible.⁷⁵

In some instances a landlord may be required to make capital improvements to his rental housing, while rent regulations do not allow the relative costs to be recovered through rental charges.⁷⁶ When the requirement is assisted by legal sanctions for not making capital improvements and not maintaining minimal housing standards, the landlord is faced with a choice between legal penalties or financial hardship.⁷⁷ That a landlord's costs are rising faster than permissible rents or that the landlord is sustaining economic losses does not, in itself, make such rent regulation unconstitutional.⁷⁸

Some rent regulations attempt to address the landlord's cost problem by tying rent adjustments to increases in the Consumer Price Index (CPI). Such adjustments may, however, be limited to a percentage less than 100% of the increase in prices indicated by the CPI.⁷⁹ Adjustments on this basis do not overcome the disincentives of investing in rental housing. By receiving periodic rent adjustments that are as little as 50% of the annual increase in the CPI, the landlord's rent revenue continually lags behind inflation.

view, it is highly desirable (though not mandatory) that municipalities enact, as part of their rent control ordinance, provisions under which landlords will be assured a just and reasonable return.

68 N.J. 604, 620, 350 A.2d 34, 42 (1975).

⁷³ See *Zussman v. Rent Control Bd. of Brookline*, 371 Mass. 632, 638-40, 359 N.E.2d 29, 33-34 (1976). In *Zussman* the Rent Board used a property value of \$550,000 even though the landlord had just paid \$700,000. *Id.* at 638, 359 N.E.2d at 33. The court found that the cost of 100 percent financing actually used by the landlord did not have to be considered since the landlord should have considered more conservative financing at seventy percent of fair market value. *Id.* at 639-40, 359 N.E.2d 34.

⁷⁴ *Id.* at 637, 359 N.E.2d at 32; *Troy Hills Village v. Township Council of Parsippany-Troy Hills*, 68 N.J. 604, 622, 350 A.2d 34, 43 (1975). See also Berger, *The New Residential Tenancy Law — Are Landlords Public Utilities?*, 60 NEB. L. Rev. 707, 716-27 (1981) (arguing that rental housing is being treated like other industries subject to price and rate controls, and may therefore be like a public utility) [hereinafter cited as Berger].

⁷⁵ *Zussman v. Rent Control Bd. of Brookline*, 371 Mass. 632, 637, 359 N.E.2d 29, 32 (1976) (rent control can be unlike public utility rate regulation when it is used to establish the lowest rent that is not confiscatory rather than to establish a rent that provides landlords with the lowest return that will cover costs while providing ample incentive to come into and stay in the market); *Troy Hills Village v. Township Council of Parsippany-Troy Hills*, 68 N.J. 604, 622, 350 A.2d 34, 43 (1975). See also Berger, *supra* note 74, at 716-27.

⁷⁶ See, e.g., *Brunetti v. Borough of New Milford*, 68 N.J. 576, 595-96, 350 A.2d 19, 29 (1975).

⁷⁷ *Id.* at 596, 350 A.2d at 29.

⁷⁸ *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 571-72, 350 A.2d 1, 16 (1975).

⁷⁹ *Brunetti v. Borough of New Milford*, 68 N.J. 576, 584, 592, 350 A.2d 19, 23, 27 (1975); *Hutton Park Gardens v. Town Council of West Orange*, 68 N.J. 543, 554, 572, 350 A.2d 1, 6, 16 (1975). The effect of a less than 100 percent Consumer Price Index (CPI) adjustment can be illustrated by an example. Assume a rent adjustment limited to fifty percent of the increase in the CPI. If the CPI goes up ten percent, the rent required to maintain a real rent return of \$100 per month should be allowed to increase to \$110 per month, but instead will only increase to \$105 (fifty percent of the ten percent increase in the CPI). Thus, the landlord loses real income with each increase in the CPI.

Every year the landlord finds that rental income is less in "real or constant" dollars. Individuals cannot be expected to continue investing in properties, the value of which decreases as profitability is continually eroded by inflation.

The general public showed just how important real returns on investment were when the rapid inflation of the early 1980's surpassed the regulated five percent rate of return on their passbook savings accounts. In response to this below market rate of return, consumers transferred millions of dollars from their savings accounts to less regulated money market funds and other savings alternatives that offered positive rather than negative real returns on their money.⁸⁰ Investors in rental housing are no different from other investors or the general public. To the extent that rent controls ensure that rental housing will provide inadequate returns, individuals will seek alternative investment opportunities. In this manner the regulation of rate of return, whether it be on passbook accounts or on rents, has the same effect of moving investment monies to other more profitable alternatives; in the first instance to mutual funds and in the latter to housing that is not rent controlled, or other investments.

Many employees and recipients of governmental benefits have their salaries and benefits indexed to the CPI or a similar index that responds to inflation. Few politicians, however, are willing to tell these people that their salaries or benefits increases should be set at a rate below the inflation rate. Indeed, some of these employees may even be tenants in rent controlled buildings. While their landlord is limited to rent adjustments below current market rates, these tenants receiving salaries or benefits fully adjusted for inflation may actually be getting, at least indirectly, a double return on their money allocated to cover housing costs. Since the CPI ostensibly accounts for market increases in housing costs, these tenants get a full adjustment for this purpose. Since the landlord is limited in his or her ability to adjust rents upward, however, the tenant finds that rent actually decreases in real terms. The tenant ends up with more disposable income that can be used for non-housing purposes. Although this situation may be beneficial for some current tenants, it is hard to see how it will encourage people to construct, own, or invest in residential rental property.⁸¹

Rent regulations create disincentives for private investment in residential rental property.⁸² They are also contrary to the current political trend favoring private initiative while reducing governmental regulation. While localized short-term rental housing shortages may occur, the presence of a shortage is not evidence of a market conspiracy by landlords and it should not form the basis for attempts to emasculate the profitability of

⁸⁰ See generally M. MADISON & J. DWYER, *THE LAW OF REAL ESTATE FINANCING* §§ 2.02(3)(a), exhibit 2.4c, 2.02(3)(e) (Supp. No. 2, 1983) (disintermediation problem).

⁸¹ See generally *Kargman v. Sullivan*, 582 F.2d 131, 131-32 (1st Cir. 1978). This case involved section 21(d)(3) of the National Housing Act, 12 U.S.C. 17151(d)(3), relating to subsidized apartment projects. *Id.* Even though HUD had strict guidelines on rent increases to protect tenants, the City of Boston was allowed to reduce the rate of return further under its local rent controls. *Id.* *But cf.* *Marshal House, Inc. v. Rent Control Bd. of Brookline*, 358 Mass. 686, 693, 266 N.E.2d 876, 882 (1971); *City of Miami Beach v. Frankel*, 363 So. 2d 555, 557 (Fla. 1978). Both of these cases involve luxury apartments exempt from local rent controls, a situation providing incentive to build luxury housing and disincentive to build housing for the poor.

⁸² See Edgerton, *Your Best Investments For 1984*, MONEY, Jan. 1984, 52, 65. Money magazine recommended that the best investments were in real estate for 1984, including multi-unit residential rental property, but specifically noted that the investor should avoid building in cities that have rent control. *Id.*

residential rental property ownership.⁸³ Short-term shortages observed in the rental housing market are no different from such shortages observed in other reasonably competitive markets.⁸⁴ A temporary demand for rental housing that exceeds its current supply will push rents higher, making investment in the market more attractive. With more attractive investment potential, additional rental housing will be supplied until a new market equilibrium is reached.

If rents are not allowed to rise, fewer incentives will exist for adding new units to the stock of rental housing. Furthermore, as long as rents are kept artificially low, a below market rate equilibrium will be established, generating increasing demand pressure for rental housing as people seek inexpensive shelter, creating further market distortion and increased upward pressure on rents. This vicious circle will lead to an outcry for more regulation of rents so that landlords will not be able to "take advantage" of the rental housing shortage. Rent control in turn will ensure that the shortage continues.

Rent regulations lead landlords to manipulate the law in attempts to avoid compliance,⁸⁵ to divest of residential rental properties,⁸⁶ to refrain from maintenance or capital improvements,⁸⁷ or to abandon their rent controlled properties altogether.⁸⁸ The persons who seemingly benefit from rent controls are tenants currently enjoying possession of rent-controlled housing. Their short-term gain, however, is offset by the long-term societal loss of rental housing stock. Beyond the short term, both current and future tenants will suffer from the disincentives to repair and improve existing rental stock.

To the extent that a coherent national policy for rental housing seeks to rely on the operation of the market place, it must accept the need for increased rent levels to attract private investment. In so doing, national policy cannot ignore the needs of the low-to-moderate-income renter. The low-to-moderate-income renter, however, can be protected by a "safety net" of government benefits, without disrupting the entire housing market. Rather than rent regulations that drive private investment out of the rental housing market, modified rental vouchers or subsidies could be made available to those potential renters who need financial assistance to ensure their economic access to adequate shelter.⁸⁹ With these kinds of subsidies, an incentive to construct rental housing in any

⁸³ See generally *City of Miami Beach v. Forte Towers, Inc.*, 305 So. 2d 764, 772 (Fla. 1974) (Roberts, J., dissenting); *Fresh Pond Shopping Center, Inc. v. Callahan*, 388 Mass. 1051, 446 N.E.2d 1060, *appeal dismissed*, 104 S.Ct. 218 (1983); see also 104 S.Ct. at 218-20 (Rehnquist, J., dissenting).

⁸⁴ See A. Downs, *supra* note 53, at 2, which states: "Eight out of nine occupied rental units are provided by private owners for profit; the ninth is publicly subsidized. Private rental markets are dominated by small scale operators. About 60 percent of all rental units are in structures with fewer than five units." See also REPORT, *supra* note 1, at 90. Both of these authorities indicate that a reasonable basis for competition within the rental housing market exists.

⁸⁵ See *Somma v. Hazlehurst & Savelli*, [1978] 1 W.L.R. 1014, 1024-25, [1978] 2 All E.R. 1011; *Aldrington Garages, Ltd. v. Fielder*, [1978] 37 P. & C.R. 461, 471-72 (both cases allowing landlords to avoid rent control acts in England by redefining the possession of the tenant as a license rather than a tenancy, and thereby taking it out of the jurisdiction of rent control acts). See also *Buchmann v. May* [1978] 2 All E.R. 993, 998-1000, 120 Sol. J. 384, (landlord avoids British Rent Acts by declaring his possession as one for a "holiday," thereby fitting into an exemption from regulation). *Contra Walsh v. Griffiths-Jones*, [1978] 2 All E.R. 1002, 1010. See generally *Case & Comment, Lease or License to Evade the Rent Act*, 38 CAMBRIDGE L.J. 38, 38-44 (1979).

⁸⁶ REPORT, *supra* note 1, at 92.

⁸⁷ *Id.*

⁸⁸ *Id.* See, e.g., Guenther, *Landlord's Unusual Response*, *supra* note 59, at 31, col. 1.

⁸⁹ See *infra* notes 173-79 and accompanying text for a discussion of a proposal for a modified voucher system.

community where demand exceeds supply will still exist. Even if new rental housing is too expensive for the unsubsidized renters, a combination of subsidy and "trickle down" or "filtering" should suffice to ensure them shelter.⁹⁰

As the need for rental housing increases in the 1980's and beyond, it is becoming important to reassess policies affecting investment in residential rental property. Currently, rent regulations are seen as a popular stop-gap measure to protect tenants from perceived abuses that might arise from a rental housing shortage. Such policies, however, seem ill-conceived and work to create disincentives rather than incentives for meeting our nation's need for additional rental housing. Furthermore, they fail to provide any real long-term benefits to the community as a whole and work to ensure a continuation of the rental housing shortage.

B. Regulation of the Landlord and Tenant Relationship

While rent controls provide one disincentive to invest in residential rental housing, other disincentives exist as well. In this light, it is important to consider the landlord and tenant relationship. Over the years, the relationship between landlord and tenant has become more complex.⁹¹ Urbanization and the movement of tenants to high rise apartment buildings with common facilities shared by all tenants, but within the control of the landlord, has fostered governmental concern for the maintenance of minimum standards of safety and health.⁹² Building codes and legislation establishing duties and rights of landlords and tenants reflect these standards.⁹³ Some of these regulations such as minimum standards for safe electrical wiring or structural soundness are desirable. Other regulations have been passed to regulate the relationship between landlord and tenant by setting out minimal standards of responsibility that each party must undertake.⁹⁴ Unfor-

⁹⁰ See Hirsch, Hirsch & Margolis, *Regression Analysis of the Effects of Habitability Laws Upon Rent: An Empirical Observation on the Ackerman-Komesar Debate*, 63 CALIF. L. REV. 1098, 1117-18 (1975).

⁹¹ See generally Rabin, *supra* note 54, at 517; Glendon, *The Transformation of American Landlord-Tenant Law*, 23 B.C.L. REV. 503 (1982) [hereinafter cited as Glendon]; Quinn & Phillips, *The Law of Landlord-Tenant: A Critical Evaluation of the Past with Guidelines for the Future*, 38 FORDHAM L. REV. 225, 225-58 (1969) [hereinafter cited as Quinn & Phillips]. See also *Green v. Superior Court*, 10 Cal. 3d 616, 622-25, 517 P.2d 1168, 1171-74, 111 Cal. Rptr. 704, 707-10 (1974); *Boston Hous. Auth. v. Hemingway*, 363 Mass. 184, 188-90, 293 N.E.2d 831, 837-38 (1973). In general, the articles and cases indicate that in evolving, landlord and tenant law has moved from real property to contract law emphasis, and from a focus on the value of the land itself to more of a service contract for living space. Early leases were for agrarian purposes in which the tenant was concerned with the land and being left alone by the landlord. Now, tenants want safe buildings and for the landlord to maintain electrical, plumbing, and other facilities — the land itself is almost meaningless to the urban tenant.

⁹² See generally *Green v. Superior Court*, 10 Cal. 3d 616, 623-25, 517 P.2d 1168, 1172-74, 111 Cal. Rptr. 704, 708-09 (1974); Glendon, *supra* note 91, at 508-09; Quinn & Phillips, *supra* note 91, at 230-39. See also, *Javins v. First Nat'l Realty Corp.*, 428 F.2d 1071, 1075 (D.C. Cir. 1970) (in the current legal environment, a lease is dominated more by contract law principles than by traditional property law principles).

⁹³ See Glendon, *supra* note 91, at 518-21. From the early to mid-1900's there was the rise of the 20th century administrative state that imposed more duties on the landlord-tenant relationship. *Id.* The passage of the Housing Act of 1949 established a national policy of providing "a decent home and suitable living environment for every American family." *Id.* at 519. By the 1950's, local building codes setting standards for housing became popular and were widely adopted by cities seeking to qualify for federal urban renewal funds. *Id.*

⁹⁴ The Uniform Residential Landlord Tenant Act (URLTA) represents an example of a major attempt at legislative reform of landlord-tenant relationships. See Glendon, *supra* note 91, at 523. The URLTA provides specific landlord obligations for such things as tenant security deposits, UNIF.

tunately, these standards adversely affect the desirability of residential rental property as an investment.⁹⁵ The effect of regulation of the landlord and tenant relationship is best explored by looking at the developing law of implied warranties of habitability and specific additional regulations.

Many state statutes have codified the implied warranty of habitability for rental housing.⁹⁶ Together with housing code regulations, the implied warranty of habitability is designed to guarantee tenants a safe and healthy living environment. The degree to which these regulations have been effective in practice, however, and the extent to which they have adversely affected the cost of rental housing are in dispute.⁹⁷

RESIDENTIAL LANDLORD TENANT ACT (URLTA) § 2.101, 7A U.L.A. 499 (1978 and Supp. 1985), disclosure of relevant leasing information, URLTA § 2.102, and maintenance and repair, URLTA § 2.104. Additional obligations are imposed on tenants for upkeep of their rental units. URLTA §§ 3.101-3.104. Significant enforcement ability is given to the tenant in the remedies section of the URLTA, and various limitations are put on the landlord's ability to obtain summary eviction or enforce self-help. See URLTA §§ 4.101-4.207. Section 4.101 basically provides a warranty of habitability; section 4.104 allows rent deductions and the tenant obtaining services elsewhere, much like "cover" under the Uniform Commercial Code; section 4.105 allows the tenant to raise landlord noncompliance with any provision of the URLTA as a defense to the landlord's action for rent or possession; and section 4.201 allows a landlord to terminate a lease if the tenants are causing a health or safety hazard in their use or possession. Even states that have not fully adopted the URLTA have been influenced by it in their judicial decisions, or have adopted parts of it. Glendon, *supra* note 91, at 523. States statutes adopting URLTA are: ALASKA STAT. §§ 34.03.010-380 (1974); ARIZ. REV. STAT. ANN. §§ 33-1301 to -1381 (1973 & Supp. 1984-85); FLA. STAT. ANN. §§ 83.40-.64 (West 1973 & Supp. 1984); HAWAII REV. STAT. §§ 521-1 to -78 (1972 & Supp. 1984); IOWA CODE ANN. §§ 562A.1-.37 (West 1979 & Supp. 1984); KAN. STAT. ANN. §§ 58-2540 to -2573 (1983); KY. REV. STAT. ANN. §§ 383.500-.715 (Bobbs-Merrill 1972 & Supp. 1984); MONT. CODE ANN. §§ 70-24-101 to -442 (1983); NEB. REV. STAT. §§ 76-1401 to -1449 (1975 & Supp. 1981); N.M. STAT. ANN. §§ 47-8-1 to -51 (1978); OKLA. STAT. ANN. tit. 41, §§ 101-136 (West Supp. 1984-85); OR. REV. STAT. §§ 91.700-900 (1973 & Supp. 1981); TENN. CODE ANN. §§ 66-28-101 to -516 (1982 & Supp. 1984); VA. CODE §§ 55-248.2 to -248.40 (1974 & Supp. 1983).

States, in addition to the above-listed states, with statutes on or amounting to an implied warranty of habitability include: CAL. CIV. CODE §§ 1941, 1941.1 (West 1954 & Supp. 1985); CONN. GEN. STAT. ANN. § 47a-7 (West Supp. 1984); DEL. CODE ANN. tit. 25, § 5303 (1974); LA. REV. STAT. ANN. §§ 2692-2693 (West 1952); ME. REV. STAT. ANN. tit. 14, § 6021(2) (West 1964); MICH. STAT. ANN. § 26.1109 (Callaghan 1984); MINN. STAT. ANN. § 504.18 (West 1983); NEV. REV. STAT. § 118A.290 (1979); N.H. REV. STAT. ANN. § 48-A:14 (Supp. 1983); N.J. STAT. ANN. §§ 2A:42-88 (West Supp. 1984-85); N.Y. REAL PROP. LAW § 235-b (McKinney Supp. 1984-85); N.C. GEN. STAT. § 42-42 (1984); N.D. CENT. CODE § 47-16-13.1 (1978); OHIO REV. CODE ANN. § 5321.04 (Baldwin 1983); R.I. GEN. LAWS § 34-18-16(1) (1984); S.D. CODIFIED LAWS ANN. § 43-32-8 (1983); WASH. REV. CODE ANN. § 59.18.060 (Supp. 1984-85); W. VA. CODE § 37-6-30 (1985); WIS. STAT. ANN. § 704.07 (West 1981 & Supp. 1984-85).

⁹⁵ When rent controls are taken into account, one author has likened the current state of residential rental property ownership to that of being regulated as a public utility. See Berger, *supra* note 74, at 716-18, 731-33, 742-43. The investment potential and consideration for operating a public utility are substantially different than for private investment in otherwise competitive or quasi-competitive markets. *Id.*

⁹⁶ See *supra* note 94 for a listing of states with statutes expressly recognizing the implied warranty of habitability and states providing comprehensive statutory provisions that amount to the same type of protection for the tenant.

⁹⁷ See generally Ackerman, *Regulating Slum Housing Markets on Behalf of the Poor: Of Housing Codes, Housing Subsidies and Income Redistribution Policy*, 80 YALE L.J. 1093, 1093-1197 (1971); Komesar, *Return to Slumsville: A Critique of the Ackerman Analysis of Housing Code Enforcement and the Poor*, 82 YALE L.J. 1175 (1973); Ackerman, *More on Slum Housing and Redistribution Policy: A Reply to Professor Komesar*, 82 YALE L.J. 1194 (1973); Heskin, *The Warranty of Habitability Debate: A California Case Study*,

The landmark case on the implied warranty of habitability is *Javins v. First National Realty Corporation*.⁹⁸ In *Javins*, the United States Court of Appeals for the District of Columbia Circuit was presented with a landlord's action for possession based on a tenant's failure to pay rent.⁹⁹ Judge Skelly Wright, in evaluating the changing nature of residential rental property ownership, decided that leases of urban dwelling units should be construed like contracts for other goods and services.¹⁰⁰ Judge Wright concluded that such contracts should therefore include implied warranties of quality and fitness for the ordinary purpose of habitation.¹⁰¹ The District of Columbia housing code was the basis for measuring the standards of the implied warranty that Judge Wright read into the lease.¹⁰² The court held that a tenant could withhold rent on the basis of a landlord's violation of the housing code, and could not be evicted for nonpayment.¹⁰³ The court accordingly gave the tenant a defense against the landlord's action for rent or possession when the landlord breached the implied warranty of habitability.¹⁰⁴

Other significant cases have followed the circuit court's reasoning in *Javins*.¹⁰⁵ The California Supreme Court applied the *Javins* reasoning while denouncing a landlord's attempt to exculpate him or herself from noncompliance with the requirements of habitability.¹⁰⁶ The court held that such exculpatory clauses in a lease were invalid as

66 CALIF. L. REV. 37 (1978); Hirsch, Hirsch & Margolis, *Regression Analysis of the Effects of Habitability Laws Upon Rent: An Empirical Observation on the Ackerman-Komesar Debate*, 63 CALIF. L. REV. 1098 (1975); Meyers, *The Covenant of Habitability and the American Law Institute*, 27 STAN. L. REV. 879 (1975). See also Brakel & McIntyre, *The Uniform Residential Landlord and Tenant Act (URLTA) in Operation: Two Reports*, 1980 AM. B. FOUND. 555; Note, *The Great Green Hope: The Implied Warranty of Habitability in Practice*, 28 STAN. L. REV. 729 (1976).

⁹⁸ *Javins v. First Nat'l Realty Corp.*, 428 F.2d 1071 (D.C. Cir. 1970), cert. denied, 400 U.S. 925 (1970).

⁹⁹ 428 F.2d at 1073.

¹⁰⁰ *Id.* at 1075; see also Rabin, *supra* note 54, at 549. In a letter to the author, Judge Wright admitted that concern for racial turmoil and the disparity of wealth between black slum-house tenants and white slum-house landlords played a factor in his landlord-tenant decisions. *Id.*

¹⁰¹ *Javins*, 428 F.2d at 1075.

¹⁰² *Id.* at 1081.

¹⁰³ *Id.* at 1082. Judge Wright adopted the contract notion of dependent covenants allowing tenants to avoid rental payments, since the apartment building was not in compliance with the housing code. *Id.* at 1082-83. This approach is in contrast to the common-law rule of independent covenants that would require the tenant to pay rent, even when the landlord was in breach of the lease. *Id.*

¹⁰⁴ *Id.* at 1082. See also *Knight v. Hallsthammar*, 29 Cal. 3d 46, 59, 623 P.2d 268, 276, 171 Cal. Rptr. 707, 715 (1981); *Boston Hous. Auth. v. Hemingway*, 363 Mass. 184, 199-202, 293 N.E.2d 831, 843-45 (1973); *Jack Spring, Inc. v. Little*, 50 Ill. 2d 351, 366, 280 N.E.2d 208, 217 (1972).

¹⁰⁵ See, e.g., *Green v. Superior Court*, 10 Cal. 3d 616, 623, 642, 517 P.2d 1168, 1172, 1184, 111 Cal. Rptr. 704, 708, 720 (1974); *George Washington University v. Weintraub*, 458 A.2d 43, 45-47 (D.C. 1983); *Boston Hous. Auth. v. Hemingway*, 363 Mass. 184, 195-99, 193 N.E.2d 831, 841-43 (1973); *Park West Management Corp. v. Mitchell*, 47 N.Y.2d 316, 324, 391 N.E.2d 1288, 1292, 418 N.Y.S.2d 310, 314 (1979), cert. denied, 444 U.S. 992 (1979); *Kamarath v. Bennett*, 568 S.W.2d 658, 660-61 (Tex. 1978); see also *Mansur v. Eubanks*, 401 So. 2d 1328, 1329-30 (Fla. 1981) (adopting implied warranty of habitability); *Pole Realty Co. v. Sorrells*, 84 Ill. 2d 178, 182, 417 N.E.2d 1297, 1300 (1981) (deciding that implied warranty of habitability applies to single family homes, not just apartment buildings, because tenants have same reasonable expectations). *Contra Blackwell v. Del Bosco*, 191 Colo. 344, 347-48, 558 P.2d 563, 565 (1976). The dissent in *Blackwell* argued the position of *Javins*. *Id.* at 348-51, 558 P.2d at 566-67 (Pringle, C.J., dissenting).

¹⁰⁶ *Henriouille v. Marin Ventures, Inc.*, 20 Cal. 3d 512, 517-18, 573 P.2d 465, 468, 143 Cal. Rptr. 247, 250 (1978). See also *Knight v. Hallsthammar*, 29 Cal. 3d 46, 52, 623 P.2d 268, 271, 171 Cal. Rptr. 707, 710 (1981) (public policy and landlords' superior bargaining power preclude tenants' waiver of warranty of habitability).

against public policy.¹⁰⁷ Two other courts have applied the *Javins* reasoning to hold a landlord responsible for breach of an implied warranty of habitability when non-compliance was the result of third-party action or inaction.¹⁰⁸ Breach of the implied warranty of habitability has recently become more than a tenant defense to an action for rent or possession; it can now form the basis for an affirmative action for damages against a landlord.¹⁰⁹

The implied warranty of habitability has placed higher penalties on landlords for not complying with government standards for rental housing. The implied warranty has given tenants an affirmative claim for damages as well as a defense against landlords in actions for rent or possession. This increased risk of liability affects the calculus of profitability of investing in rental housing. Externally imposed standards for construction, operation, and repair of rental housing raise the cost of owning such housing. For the marginally profitable landlord, who would otherwise rent below standard premises at below market rates, these additional costs may cause divestment. Likewise, the tenant's ability to raise defenses and affirmative claims for damages in the landlord's action for rent or possession adds to the cost of owning rental housing by making negotiation and litigation of disputes more complex and time-consuming. All of these cost factors need to be considered when the law is used to establish an "acceptable" minimum standard of habitability. The landlord's response, especially the marginally profitable landlord, to unrealistic standards may be withdrawal from the rental housing market altogether. The consequence of this withdrawal could be the dislocation of tenants from "substandard" housing to no housing.

¹⁰⁷ *Henriouille v. Marin Ventures, Inc.*, 20 Cal. 3d 512, 518-19, 573 P.2d 465, 468-69, 143 Cal. Rptr. 247, 250-51 (1978). This case sets out the six criteria used by the court to find exculpatory clauses invalid as contrary to public policy. *Id.* at 518, 573 P.2d at 468, 143 Cal. Rptr. at 250. The six factors the court identified are: (1) the agreement concerns a business generally thought suitable for public regulation; (2) the party seeking exculpation is engaged in performing a service of great importance to the public; (3) the party holds itself out as willing to perform for any member of the public; (4) the party seeking exculpation has superior bargaining power; (5) using superior bargaining power a standardized contract of adhesion is used to obtain exculpation; and (6) the person or property of the purchaser comes under the control and risk of the party obtaining the exculpatory clause. *Id.*

¹⁰⁸ See *Berman & Sons, Inc. v. Jefferson*, 379 Mass. 196, 200-03, 396 N.E.2d 981, 984-85 (1979) (under implied warranty of habitability, landlord is responsible for condition of rental unit, even if defects are due to no fault of landlord); *Park West Management Corp. v. Mitchell*, 47 N.Y.2d 316, 326-30, 391 N.E.2d 1288, 1293-95, 418 N.Y.S.2d 310, 315-18, *cert. denied*, 444 U.S. 992 (1979) (landlord has a nondelegable duty to maintain rental property in habitable condition and the fact that a workers' strike prevented the removal of garbage from the premises does not excuse the landlord).

¹⁰⁹ See *George Washington University v. Weintraub*, 458 A.2d 43, 45-47 (D.C. 1983); *Simon v. Solomon*, 385 Mass. 91, 96-98, 431 N.E.2d 556, 561-62 (1982) (a breach of the implied warranty by the landlord results not only in an affirmative action for damages, but also can be the basis of an action for emotional distress). *But see* *Wolfberg v. Hunter*, 385 Mass. 390, 396-97, 432 N.E.2d 467, 471-72 (1982) (landlord not liable under consumer protection statute for the emotional distress of the tenant when the premises become infested with rodents). See also *Alexander v. United States Dep't of Hous. & Urban Dev.*, 555 F.2d 166, 170-77 (7th Cir. 1977), *aff'd*, 441 U.S. 39 (1979). In *Alexander*, the Seventh Circuit held that a federal housing project for low income families did not carry an implied warranty of habitability even though:

[t]he project was infested with roaches and vermin; elevators were often inoperable; security was poor; hot water and heat were inadequate or non-existent; the buildings were often flooded; lighting was poor in the narrow hallways which were often cluttered with garbage; plumbing was deficient; and some tenants had electrical problems.

Id. at 167-68.

C. Additional Landlord and Tenant Regulations

Many states have provided additional guidelines beyond the implied warranty of habitability for the regulation of the landlord and tenant relationship. These additional requirements, like the requirements for habitability, are directed toward providing a "better" rental housing environment while clarifying reasonable expectations of the duties and rights of each party to the residential lease. The Uniform Residential Landlord and Tenant Act (URLTA) illustrates the broad spectrum of these regulations.¹¹⁰

Other state and local regulations affecting the landlord and tenant relationship involve: the tenant's right to criticize, organize for action against, or withhold rent from the landlord;¹¹¹ the tenant's right to offset rental payments or to apply rent directly to repairs;¹¹² the tenant's right to rescind the lease on the basis of the uninhabitability of the premises or the landlord's failure to repair or comply with comprehensive statutory provisions for upkeep of the premises;¹¹³ the tenant's right to have a receiver appointed to collect all rents from an entire building until the landlord makes repairs;¹¹⁴ prohibitions on the landlord's ability to select tenants and the prevention of discrimination against

¹¹⁰ For a listing of states that have adopted URLTA and citations to the statutes, see *supra* note 94. See generally *Brewer v. Erwin*, 287 Or. 435, 447-49, 600 P.2d 398, 408-10 (1979). The Oregon version of URLTA allows for the recovery of noneconomic damages resulting from a violation of the statute including recovery for physical and emotional distress. *Id.*

¹¹¹ See ME. REV. STAT. ANN. tit. 14, § 6001(4) (Supp. 1984-85); MD. REAL PROP. CODE ANN. § 8-203.1(b) (1981); MASS. GEN. LAWS ANN. ch. 186, § 18 (West Supp. 1984-85); NEV. REV. STAT. § 118A.510(1)(c) (1979); N.M. STAT. ANN. § 47-8-39 (1978); N.Y. REAL PROP. LAW § 230 (McKinney Supp. 1984-85); OHIO REV. CODE ANN. § 5321.02(A)(3) (Baldwin 1983);

¹¹² See UNIF. RESIDENTIAL LANDLORD TENANT ACT §§ 4.103(a), 4.104(a)(1), 7B U.L.A. at 481-83 (1978 & Supp. 1985); ARIZ. REV. STAT. ANN. § 33-1363 (1974); CAL. CIV. CODE § 1942 (West Supp. 1984); CONN. GEN. STAT. ANN. § 47a-13 (West Supp. 1984); DEL. CODE ANN. tit. 25, § 5306 (1974); FLA. STAT. ANN. § 83.56(10)(b) (West Supp. 1983); HAWAII REV. STAT. § 521-64(b)(1) (Supp. 1984); KY. REV. STAT. ANN. § 383.635(1) (Bobbs-Merrill Supp. 1984); LA. CIV. CODE ANN. Art. 2694 (West 1952); ME. REV. STAT. ANN. tit. 14, § 6026(2) (Supp. 1984-85); MD. REAL PROP. CODE ANN. § 8-211(h)(2) (1981); N.Y. REAL PROP. LAW § 235-a (McKinney Supp. 1984-85); N.D. CENT. CODE 47-16-13(1) (1978); OKLA. STAT. ANN. tit. 41, § 121(B) (West Supp. 1984-85); OR. REV. STAT. § 91.805 (Supp. 1983); S.D. CODIFIED LAWS ANN. § 43-32-9 (Supp. 1983); WASH. REV. CODE ANN. § 59.18.100 (Supp. 1984-85).

¹¹³ See UNIF. RESIDENTIAL LANDLORD TENANT ACT §§ 4.101, 4.107, 7B U.L.A. at 478, 488 (1978 & Supp. 1985); ALASKA STAT. § 34.03.160 (1975); ARIZ. REV. STAT. ANN. § 33-1361 (1974); CAL. CIV. CODE § 1942 (West Supp. 1985); CONN. GEN. STAT. ANN. § 47a-12 (West Supp. 1984); DEL. CODE ANN. tit. 25, § 5307 (Supp. 1984); FLA. STAT. ANN. § 83.56 (West Supp. 1984); IOWA CODE ANN. § 562A.21(1) (West 1979 & Supp. 1984-85); KAN. STAT. ANN. § 58-2559(a) (1983); KY. REV. STAT. ANN. § 383.625(1) (Bobbs-Merrill Supp. 1984); ME. REV. STAT. ANN. tit. 14, § 6002(3) (Supp. 1984-85); MONT. CODE ANN. § 70-24-406(1)(a) (1983); NEB. REV. STAT. § 76-1425(1) (1976); NEV. REV. STAT. § 118A.350 (1979); N.M. STAT. ANN. § 47-8-29 (1978); N.C. GEN. STAT. § 42-12 (1984); N.D. CENT. CODE §§ 47-16-17(1), 47-16-13(3) (1978 & Supp. 1983); OHIO REV. CODE ANN. §§ 5321.02(B)(3), 5321.07(B)(3) (Baldwin 1983); OKLA. STAT. ANN. tit. 41, §§ 121(A), 121(D) (West Supp. 1984-85); OR. REV. STAT. § 91.800 (1983); R.I. GEN. LAWS § 34-18-7 (1984); S.D. CODIFIED LAWS ANN. §§ 43-32-9, 43-32-19 (1983); VA. CODE § 55-248.21 (Supp. 1984); WASH. REV. CODE ANN. § 59.18.090 (Supp. 1984-85).

¹¹⁴ Appointment of a receiver, of course, would leave the landlords with a severe cash flow problem and might even make it economically impossible for the landlord to make needed repairs. See CONN. GEN. STAT. ANN. § 47-14(d) (West Supp. 1984); DEL. CODE ANN. tit. 25, § 5904 (1974); MD. REAL PROP. CODE ANN. § 8-211(n)(3) (1981); MASS. GEN. LAWS ANN. ch. 111, § 127(H) (West 1983); MINN. STAT. ANN. § 566.25(1) (West 1983); MO. ANN. STAT. § 441.590 (Vernon Supp. 1985); N.J. STAT. ANN. § 2A:42-79 (West Supp. 1984-85); N.Y. REAL PROP. LAW § 778 (McKinney Supp. 1984-85).

various classes of tenants;¹¹⁵ and increased landlord liability for injuries to tenants.¹¹⁶

The willingness of private parties to assist in the enforcement of these regulations is

¹¹⁵ See ARIZ. REV. STAT. ANN. § 33-1317 (1974); ME. REV. STAT. ANN. tit. 14, § 6024 (Supp. 1984-85); MINN. STAT. ANN. § 504.265 (West 1983); N.J. STAT. ANN. § 2A:42-101 (West Supp. 1984-85); N.Y. REAL PROP. LAW § 236 (McKinney Supp. 1984-85); Friedman, *Comments on Edward H. Rabin, The Revolution in Residential Landlord-Tenant Law: Causes and Consequences*, 69 CORNELL L. REV. 585, 589-91 (1984) (discussing the need to assure access to housing for all people, including families with young children); Note, *Real Property — Prospective Tenant Denied Housing Because of Adults-Only Policy Has Cause of Action Under Fourteenth Amendment and Fair Housing Act — Halet v. Wend Investment Co.*, 672 F.2d 1305 (9th Cir. 1982), 23 SANTA CLARA L. REV. 965 (1983). See also Halet v. Wend Instrument Co., 672 F.2d 1305, 1311 (9th Cir. 1983) (the failure of landlords to lease to people with children could be a violation of the Federal Fair Housing Act); O'Connor v. Village Green Owners Ass'n, 33 Cal. 3d 790, 794-97, 662 P.2d 427, 429-31, 191 Cal. Rptr. 320, 322-24 (1983) (applying the California Civil Rights Acts to units in a condominium project); Marina Point, Ltd. v. Wolfson, 30 Cal. 3d 721, 736-45, 640 P.2d 115, 124-29, 180 Cal. Rptr. 496, 506-11 (1982). In *Marina Point*, a private landlord was held to have violated California's Unruh Civil Rights Act by excluding children from rental units, despite evidence that children on the premises added to wear and tear and to maintenance costs. The court's decision in *Marina Point* seems motivated by a concern regarding the exclusion of children from sixty to eighty percent of the available housing, and the fear that this exclusion would create an undue hardship on young families. 30 Cal. 3d at 729, 640 P.2d at 119, 180 Cal. Rptr. at 501. See also Moore v. City of East Cleveland, Ohio, 431 U.S. 494, 496-506 (1977) (The Court invalidated a city ordinance that defined "family" and restricted the ability of some blood relatives from sharing the same housing units); Bynes v. Toll, 512 F.2d 252, 257-58 (2d Cir. 1975) (university making housing available to married couples had no obligation to provide such housing to couples with children); Yorkshire House Assoc. v. Lulkin, 114 Misc. 2d 40, 44, 450 N.Y.S.2d 962, 966 (Civ. Ct. 1982) (a landlord cannot refuse to rent to a couple merely because they are unmarried); Stewart, *Landlords' Verdict: Lawyers as Tenants Have Little Appeal*, Wall St. J., Jan. 23, 1984, at 1, col. 4, continued at 18, col. 3. *Contra* Kramarsky v. Stahl Management, 92 Misc. 2d 1030, 1032, 401 N.Y.S.2d 943, 944-45 (Sup. Ct. 1977) (landlords can refuse to rent to attorneys because they are more troublesome tenants). See generally Village of Belle Terre v. Boraas, 416 U.S. 1, 2-10 (1974) (village allowed to define the term "family" narrowly, and thereby restrict the number of unrelated individuals permitted to live in a single housing unit); Hudson View Properties v. Weiss, 59 N.Y.2d 733, 735, 450 N.E.2d 234, 235, 463 N.Y.S.2d 428, 429 (1983) (landlord can evict tenant for allowing a boyfriend to reside in the apartment).

¹¹⁶ See Browder, *The Taming of a Duty — The Tort Liability of Landlords*, 81 MICH. L. REV. 99 (1982); see also Cain v. Vontz, 703 F.2d 1279, 1282 (11th Cir. 1983) (an exculpatory clause favoring the landlord in the lease is not effective to relieve the landlord of liability); Kline v. 1500 Massachusetts Ave. Apartment Corp., 439 F.2d 477, 486-87 (D.C. Cir. 1970) (a landmark case holding that landlords are responsible to take reasonable steps to protect tenants from foreseeable third party criminal acts); Kendall v. Gore Properties, Inc., 236 F.2d 673, 679-81 (D.C. Cir. 1956) (landlords must exercise reasonable care in employing workers who will not be dangerous to tenants); Graham v. M & J Corp., 424 A.2d 103, 105-06, 108 (D.C. 1980) (landlord liable for third party crime against a tenant because the crime was made possible due to the failure of the landlord to take reasonable precautions to protect the tenant); Spar v. Obwoya, 369 A.2d 173, 179-80 (D.C. 1977) (tenant recovered \$75,000 from his landlord for injuries received when shot by a third party in the hallway of apartment building); Scott v. Watson, 278 Md. 160, 165, 359 A.2d 548, 552 (1976) (a landlord is obligated to use reasonable diligence and ordinary care to keep common areas of buildings in safe condition); Sargent v. Ross, 113 N.H. 388, 396-400, 308 A.2d 528, 533-35 (1973) (the court abandons the common-law rule of caveat lessee, and imposes upon landlords a duty of reasonable care for the safety of their tenants); Trentacost v. Brussel, 82 N.J. 214, 225-28, 412 A.2d 436, 441-43 (1980) (a landlord's duty to make a rental unit habitable includes a minimum level of security for the protection of the tenants); Braitman v. Overlook Terrace Corp., 68 N.J. 368, 382, 346 A.2d 76, 84 (1975). *But see* Phillips v. Chicago Hous. Auth., 89 Ill. 2d 122, 129, 431 N.E.2d 1038, 1041 (1982); Pippin v. Chicago Hous. Auth., 78 Ill. 2d 204, 208-09, 399 N.E.2d 596, 598-99 (1979) (both cases holding that a governmental housing authority has no duty to provide for the personal safety of tenants against third party criminal acts unless the housing authority has undertaken such a duty).

of particular importance to their success.¹¹⁷ Tenants need confidence to be able to report housing violations without fear of retaliatory responses from the landlord.¹¹⁸ Tenants may use an allegation of retaliatory eviction as a defense in a suit by the landlord for possession of the premises or in a summary proceeding.¹¹⁹ The importance of protecting tenants from landlord retaliation has led many states to adopt anti-eviction statutes or prohibitions against retaliatory eviction.¹²⁰

Although this protection from retaliatory eviction seems reasonable, it is not without its impact on the supply and affordability of rental housing. In *Robinson v. Diamond Housing Corporation*,¹²¹ the United States Court of Appeals for the District of Columbia Circuit, in an opinion by Judge Skelly Wright, concluded that the tenant had a right to withhold rent as long as the premises were below housing code standards. The court further held that the landlord could not evict the tenant, even if the landlord would immediately take the unit off the market or was otherwise unable to pay the cost to bring

¹¹⁷ See *Bowles v. Blue Lake Dev. Corp.*, 504 F.2d 1094, 1096-97 (5th Cir. 1974); *Robinson v. Diamond Hous. Corp.*, 463 F.2d 853, 858, 861, 870-71 (D.C. Cir. 1972) (Judge Skelly Wright); *Golphin v. Park Monroe Assoc.*, 353 A.2d 314 (D.C. 1976); *Edwards v. Habib*, 227 A.2d 388 (D.C. 1967), *rev'd and rem'd*, 397 F.2d 687, 700-01 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1016 (1969) (another decision of Judge Skelly Wright).

¹¹⁸ See *Bowles v. Blue Lake Dev. Corp.*, 504 F.2d 1094, 1096-97 (5th Cir. 1974); *Robinson v. Diamond Hous. Corp.*, 463 F.2d 853, 861 (D.C. Cir. 1972) (Judge Skelly Wright); *Golphin v. Park Monroe Assoc.*, 353 A.2d 314, 317 (D.C. 1976); *Edwards v. Habib*, 227 A.2d 388 (D.C. 1967), *rev'd and rem'd*, 397 F.2d 687, 700-01 (D.C. Cir. 1968), *cert. denied*, 393 U.S. 1016 (1969) (another decision of Judge Skelly Wright). See also *Vargas v. Municipal Court of Riverside County*, 22 Cal. 3d 902, 914-17, 587 P.2d 714, 722-23, 150 Cal. Rptr. 918, 925-27 (1978) (tenant farm workers raised defense of retaliatory eviction against employer-landlord after a labor dispute arose); *S.P. Growers Ass'n v. Rodriguez*, 17 Cal. 3d 719, 724-28, 552 P.2d 721, 723-28, 131 Cal. Rptr. 761, 763-68 (1976) (involved an eviction action against tenant farm workers by landlord-agricultural employer in retaliation for the farm workers having filed a suit under the Federal Farm Labor Contractor Registration Act). *Contra Hurrucane v. Kanover, Ltd.*, 651 P.2d 1218, 1220-23 (Colo. 1982) (tenant lost on the merits of his contention that he was the victim of a retaliatory eviction due to his participation in a tenants group).

¹¹⁹ See, e.g., *Barela v. Superior Court of Orange County*, 30 Cal. 3d 244, 247-51, 636 P.2d 582, 583-85, 178 Cal. Rptr. 618, 619-21 (1981); *Clore v. Fredman*, 59 Ill. 2d 20, 26-27, 319 N.E.2d 18, 21-22 (1974). Under Illinois law, the tenant not only has a defense to a landlord's eviction action, but the tenant can also pay rent into a court escrow account during the dispute so that the landlord is unable to have access to this income until the matter is resolved. *Id.* See generally Comment, *Landlord Eviction Remedies Act — Legislative Overreaction to Landlord Self-Help*, 18 WAKE FOREST L. REV. 25 (1982) (discussing landlord eviction actions).

¹²⁰ ALASKA STAT. § 34.03.310 (1975); ARIZ. REV. STAT. ANN. § 33-1381 (1974); CAL. CIV. CODE § 1492.5 (West Supp. 1985); CONN. GEN. STAT. ANN. § 47a-20 (West 1978 & Supp. 1985); DEL. CODE ANN. tit. 25, § 5516 (1974); HAWAII REV. STAT. § 521-74 (1976); ILL. ANN. STAT. ch. 80, § 71 (Smith-Hurd 1966 & Supp. 1984-85); IOWA CODE ANN. § 562A.36 (West 1979 & 1984-85); KAN. STAT. ANN. § 58-2572 (1983); KY. REV. STAT. ANN. § 383.705 (Bobbs-Merrill Supp. 1984); ME. REV. STAT. ANN. tit. 14, § 6001(3) (Supp. 1984-85); MD. REAL PROP. CODE ANN. §§ 8-208.11, 8.206 (1981); MASS. GEN. LAWS ANN. ch. 186, § 18 (West Supp. 1984-85); MICH. COMP. LAWS § 27A.5720 (1983-84); MINN. STAT. ANN. § 566.03(2) (West 1983); MONT. CODE ANN. § 70-24-431 (1983); NEB. REV. STAT. § 76-1439 (1976); NEV. REV. STAT. § 118A.510 (1979); N.H. REV. STAT. ANN. § 540:13-a, 540:13-d(s) (Supp. 1983); N.J. STAT. ANN. §§ 2A:42-10.10 (West 1984-85); N.M. STAT. ANN. § 47-8-39 (1978); N.Y. REAL PROP. LAW § 223-b (McKinney Supp. 1983-84); N.C. GEN. STAT. § 42-37.1 (1984); OHIO REV. CODE ANN. § 5321.02 (Baldwin 1983); OR. REV. STAT. § 91.865 (1983); TENN. CODE ANN. § 66-28-514 (1982); TEX. PROP. CODE ANN. § 92.057 (Vernon 1984); VA. CODE § 55-248.39 (Supp. 1984); WASH. REV. CODE ANN. § 59.18.240 (Supp. 1984-85); WIS. STAT. ANN. § 704.45 (West Supp. 1984-85). See also D.C. CODE ANN. §§ 45-1561, 45-1562, 45-1561.1 (1981 & Supp. 1984).

¹²¹ *Robinson v. Diamond Hous. Corp.*, 463 F.2d 853 (D.C. Cir. 1972).

the unit up to code requirements.¹²² The court of appeals stated that nonpayment of rent was not a legitimate purpose for removing the tenant from possession and that the landlord would never be able to evict the tenant so long as the landlord was motivated by a desire to rid him or herself of a tenant who was not paying rent.¹²³

The result of *Robinson* seems to be that the tenant, once in possession of a below-standard apartment, is able to stay in possession without paying rent and that the landlord cannot evict the tenant or take the unit off the market. Such a policy does more than protect a tenant's right to enforce landlord and tenant regulations. It raises the spectre that a landlord may be forced to maintain an unprofitable investment and even put additional capital into it. This inability to divest of a bad rental housing investment reduces liquidity and discourages initial investment into this sector of the housing market.

Given adequate returns on investment and the prospects of unhindered liquidity, most landlords should be willing to comply with reasonable standards of construction, operation, and repair of rental housing. Yet maintenance of these standards is accompanied by a cost, and landlords need the freedom to adjust rents upward to cover the costs of complying with the standards. Restrictive rent controls cannot be imposed with the expectation of attracting investment into rental housing, if compliance with rigorous standards and regulations governing landlord and tenant relationships is to be maintained.¹²⁴ As long as the rental housing market remains reasonably competitive, rents will reflect the reasonable cost of regulatory compliance plus a market rate of return at least equal to what an investor would expect from an alternative investment of comparable risk.

Society, through the legislative process, cannot correct long-term rental housing problems by coercing compliance on landlords, while at the same time removing all financial incentives to participate in the market. The end result of such a strategy can only be creation of disincentives for investment in residential rental property, resulting in a prolonged rental housing shortage and continuous attempts by marginal landlords to undercut the standards the regulations impose.

D. Regulation of Conversions To Ownership Form

One of the results of excessive regulation of the landlord and tenant relationship combined with stringent rent regulation is the rush by landlords to divest through conversion of their residential rental property to ownership form.¹²⁵ In an attempt to keep landlords in the rental housing market, some states have adopted anti-conversion laws, or restrictions that require tenant approval or participation for a conversion to condominium or cooperative ownership form.¹²⁶

The general justifications of anti-conversion legislation are protection of tenant rights,¹²⁷ maintenance of or improvement to local rental stock,¹²⁸ and a concern that

¹²² *Id.* at 865-67.

¹²³ *Id.* at 865.

¹²⁴ See generally M. FRIEDMAN, BRIGHT PROMISES, DISMAL PERFORMANCES 105-07 (1983).

¹²⁵ See REPORT, *supra* note 1, at 92.

¹²⁶ See ARIZ. REV. STAT. ANN. § 33-1326 (Supp. 1984-85); COLO. REV. STAT. § 38-33-112 (1973); N.J. STAT. ANN. §§ 2A:18-61.8 to -61.39 (Supp. 1984-85); N.Y. GEN. BUS. LAW §§ 352-eee, 352-eeee (McKinney Supp. 1984-85); R.I. GEN. LAWS § 34-36-37 (1984). See also D.C. CODE ANN. §§ 45-1571, 45-1581 to -1585, 45-1601 to -1657 (1981 & Supp. 1984). See generally Note, *The Validity of Ordinances Limiting Condominium Conversion*, 78 MICH. L. REV. 124 (1979).

¹²⁷ See *Zussman v. Rent Control Bd. of Brookline*, 367 Mass. 561, 326 N.E.2d 876 (1975) (court, concerned about disrupting tenants by the conversion plans of landlord, stated that a

conversions are merely alternative means of charging excessive fees for shelter.¹²⁹ The operation of many of these anti-conversion regulations can involve requiring landlords to establish a tenant relocation program or pay tenants relocation costs,¹³⁰ giving tenants notice and a right of first refusal to purchase the converted units,¹³¹ allowing tenants to remain in possession of their unit after conversion,¹³² and preventing rent increases during the tenants' continued possession after a conversion to prevent de facto elimination of the tenants right to continued possession.¹³³

*Troy Ltd. v. Renna*¹³⁴ illustrates the problems of anti-conversion regulations. Plaintiffs in *Troy Ltd.* were owners of interests in an apartment complex in Springfield, New Jersey¹³⁵ that they sought to convert to a condominium.¹³⁶ The apartment complex came within comprehensive state legislation governing rental housing.¹³⁷ State law required a three year notice to all tenants,¹³⁸ which amounted to a three year right of possession by the tenants as a result of conversion.¹³⁹ The state statutes provided for an extension of possession up to five years beyond the three year period so that, in practice, if a landlord could not suitably relocate a tenant, the tenant could get extended rights of possession up to a total of eight years.¹⁴⁰ In addition, state law gave senior citizens and disabled persons special protection that allowed extended periods of possession of up to forty years.¹⁴¹ The statute controlled rents during the extended possession periods for all tenants, and provided that a landlord's costs of conversion could not be taken into account in figuring the permissible rent level.¹⁴² Alleging that this state law constituted an unconstitutional

unit-by-unit conversion was not necessarily inconsistent with rent control, although the tenants were able to hold up the landlord's project and run up the costs by posting only a \$100 bond); *Whalen v. Lefkowitz*, 36 N.Y.2d 75, 75-79, 324 N.E.2d 536, 537-38, 365 N.Y.S.2d 150, 151-54 (1975) (landlord's selling of units in apartment building will lead to gradual dilution of the tenant association's strength and significance).

¹²⁸ See generally *Bronstein v. Prudential Ins. Co. of Am.*, 390 Mass. 701, 704-05, 459 N.E.2d 772, 775 (1984) (argument raised by tenants that anti-conversion laws in Massachusetts were designed to enhance the housing stock and reduce disruptive effects of tenant relocation).

¹²⁹ See *Parkchester Apts. Co. v. Lefkowitz*, 41 N.Y.2d 987, 988-89, 363 N.E.2d 712, 712-13, 395 N.Y.S.2d 162, 162-63 (1977) (Jasen, J., dissenting).

¹³⁰ See D.C. CODE ANN. §§ 45-1571, 45-1581 to -1585, 45-1601 to -1657 (1981 & Supp. 1984); *CHR General, Inc. v. City of Newton*, 387 Mass. 351, 351-52, 439 N.E.2d 788, 789 (1982) (landlord must obtain approval for tenant relocation plan to get local approval for condominium conversion).

¹³¹ See *Columbia Plaza Tenants Ass'n, Inc. v. Antonelli*, 462 A.2d 433, 437 (D.C. 1983); *CHR General, Inc. v. City of Newton*, 387 Mass. 351, 351-52, 439 N.E.2d 788, 789 (1982).

¹³² See *AMN, Inc. of New Jersey v. Township of South Brunswick Rent Leveling Board*, 93 N.J. 518, 530, 461 A.2d 1138, 1144 (1983) (tenants are entitled to three year's notice before they can be evicted for condominium conversion; senior citizens and disabled persons cannot be evicted for up to forty years); *CHR General, Inc. v. City of Newton*, 387 Mass. 351, 352-53, 439 N.E.2d 788, 789 (1982) (tenant allowed to stay in possession after conversion, as of right for two years and possession can be extended to five years).

¹³³ See *CHR General, Inc. v. City of Newton*, 387 Mass. 351, 353, 439 N.E.2d 788, 789 (1982) (if a landlord converts rental units to a condominium and then raises the rents to force the tenants out, the rent increase will be unenforceable).

¹³⁴ *Troy, Ltd. v. Renna*, 727 F.2d 287 (3d Cir. 1984).

¹³⁵ *Id.* at 293.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ See *id.* at 289.

¹⁴⁰ *Id.* at 289-90.

¹⁴¹ *Id.* at 291.

¹⁴² *Id.* at 292.

impairment of their contract rights and a taking of their property without compensation, the plaintiffs brought an action against three tenants of the apartment complex, the State Attorney General, and the Commissioner of the State Department of Community Affairs.¹⁴³ The United States Court of Appeals for the Third Circuit held that the New Jersey regulatory provisions did not constitute an impairment of contract or an unlawful taking.¹⁴⁴

Under the New Jersey statutory scheme, the requirements involved in converting rental housing to ownership form are prohibitively time-consuming and expensive. The delay in removing non-purchasing tenants from the building requires an extended period of time between the planning of conversion and its actual completion including sale of the units by the landlord. This delay adds to financing cost, allows inflation over an extended period to affect construction and labor costs adversely, and creates disincentives for unit purchases because of the uncertainty of buyers regarding when the conversion will be complete and the remaining tenancies terminated.¹⁴⁵ The extended period of protection for senior citizens and the disabled may well extend beyond the useful life of the building. In other words, a landlord converting a property from rental use might have certain units under tenancy possession long after the building has ceased to be viable economically.¹⁴⁶

Anti-conversion legislation deters investment in conversions and may have different effects from those intended by its proponents. On the surface, the disincentives of conversion seem to accomplish the goal of preventing a massive withdrawal of rental units from the market, but in fact, the denial of an expected conversion profit can create disincentives for initial investment in rental housing. The overall quality of the housing stock as a whole suffers as well, because conversions generally require extensive updating and improvement of the buildings converted. When conversions are not easily achieved, the housing stock falls into disrepair at a faster rate than when profits could be obtained from investment in their rejuvenation.

Even when local law does not expressly prohibit conversions, indirect regulations can foster the same disincentives as anti-conversion legislation. *Flynn v. City of Cambridge*¹⁴⁷ provides an example of indirect state anti-conversion regulations. *Flynn* involved a city ordinance aimed at maintaining the supply of rental housing.¹⁴⁸ While the ordinance did not prohibit the conversion of rental housing into ownership form, it did prohibit use of the property after conversion for purposes other than rental housing.¹⁴⁹ The purchaser of the converted unit, therefore, could only use it as a rental unit and could not personally occupy it. The Supreme Judicial Court of Massachusetts held the ordinance to be con-

¹⁴³ *Id.* at 293.

¹⁴⁴ *Id.* at 297-303.

¹⁴⁵ See generally Guenther, *Investors in Occupied Co-ops Pin Hopes on Tenants Moving*, Wall St. J., May 30, 1984, at 27, col. 1. The article points out the added risks associated with buying converted units in which tenants reside and are covered by anti-conversion laws that protect their continued possession. As a result of these risks, investors are putting more emphasis on the nature, age, and health of a continuing tenant when determining the value of a unit.

¹⁴⁶ See REAL ESTATE DEVELOPMENT AND THE LAW IN THE 1980s 64-73 (R. Levitt & A. Ntephe eds. 1983) (property that was depreciable over 30-40 years under the pre-1981 tax code, and property that was depreciable over 15 years under the ACRS rules was placed under an 18 year depreciation schedule under the Tax Act of 1984, Pub. L. No. 98-369, § 111, 98 Stat. 631 (1984).

¹⁴⁷ *Flynn v. City of Cambridge*, 383 Mass. 152, 418 N.E.2d 335 (1981).

¹⁴⁸ *Id.* at 156-57, 418 N.E.2d at 337.

¹⁴⁹ *Id.* at 155-56, 418 N.E.2d at 337.

stitutional, finding no taking because the owner was able to rent the converted unit and under applicable rent regulations would get a "reasonable" return on his investment.¹⁵⁰

Both *Troy Ltd.* and *Flynn* illustrate the complexity of legislative attempts to keep landlords tied to investments in rental housing. These anti-conversion regulations are "back door" attempts to force landlords to absorb the costs of a rental housing policy that eliminates incentives for private investment and, at the same time, to maintain and enhance the availability of affordable rental housing. Landlords' attempts to leave the rental housing market reflect their determination that selling housing units is more profitable than continued ownership of rental units. In addition to reducing the expected personal profit of rental property ownership, restrictions on conversion raise the cost of leaving the rental market for tenants, and raise the cost of home ownership for those who wish to buy a converted unit. To the extent that investors are discouraged from entering the rental housing market, tenants will have less rental housing stock from which to choose, market shortages will be prolonged, and legislation will thus create additional pressure for rents to rise.

E. Restrictive Land Use and Development Regulations

In addition to such regulations as rent control and restrictions on conversions of rental property, other disincentives to the production of rental housing exist such as restrictive land use and development regulations that can add to the cost of building new housing.¹⁵¹ First, these restrictions reduce the potential size of the rental housing stock and perpetuate the upward pressure on rents. Second, by increasing the cost of new construction, land use regulations tend to eliminate lower cost housing and raise the level of rents necessary to make landlords' investments profitable.¹⁵² Some restrictions, such as necessary open space or large minimum lot sizes, raise the cost of construction on a per unit basis.¹⁵³ Other restrictions, such as those that limit the number of bedrooms in rental housing, seek to reduce, de facto, the financial burden on communities for local services.¹⁵⁴

The potential for restrictive land use regulations to raise the per unit cost of housing is an important consideration in assessing the supply of affordable housing even though such regulations may also serve a purpose of providing open space and a certain style of living for those able to afford low density or high quality housing. A reduction in unnecessary land use regulations and restrictions could significantly reduce the cost of construction in the market for rental housing.¹⁵⁵ With higher density allocations, rental

¹⁵⁰ *Id.* at 159-60, 418 N.E.2d at 339-40.

¹⁵¹ See HOUSING SUPPLY & AFFORDABILITY, *supra* note 2, at 81-89; R. MONTGOMERY & D.R. MARSHALL, HOUSING POLICY FOR THE 1980s 113-25 (1980) (chapter by David E. Douvall discusses the effects of land-use and environmental regulations on housing costs).

¹⁵² See generally Lefcoe, *The Public Housing Referendum Case, Zoning, and the Supreme Court*, 59 CALIF. L. REV. 1384, 1429-30 (1971).

¹⁵³ *Id.*

¹⁵⁴ *Id.* at 1432-34.

¹⁵⁵ See *Southern Burlington County NAACP v. Township of Mt. Laurel (Mt. Laurel II)*, 92 N.J. 158, 456 A.2d 390 (1983). See also *Oakwood at Madison, Inc. v. Township of Madison*, 72 N.J. 481, 371 A.2d 1192 (1977); *Southern Burlington County NAACP v. Township of Mt. Laurel (Mt. Laurel I)*, 67 N.J. 161, 336 A.2d 713 (1975) (these two cases lay the foundation for the decision in *Mount Laurel II*, and establish the principles of fair access and "inclusive zoning law which seeks to include people of all income groups within each community"); Rose, *The Mount Laurel II Decision: Is It Based on Wishful Thinking?*, 12 REAL EST. L.J. 115, 124 (1983) (the underlying assumption of the *Mount*

housing projects could generate more profit on a per acre acquisition cost basis and add to the incentives for investment. Added development costs due to excessive regulations and restrictions are therefore as significant a factor in attracting new investment to the rental housing market as are rent regulations, regulations governing the landlord and tenant relationship, and regulations regarding conversions of rental units to ownership form.

IV. IMPLICATIONS

A. Conflict Between Federal and State Policy

National housing policy during the past forty years has been oriented towards providing adequate shelter for all Americans.¹⁵⁶ Economic factors such as inflation and high interest rates, however, have hampered the achievement of this purpose.¹⁵⁷ Rental housing has been particularly affected during the past 20 years because residential rents have not kept pace with general prices, consumer income, or operating and construction costs for rental units.¹⁵⁸ As a result, landlords are faced with a movement of high income renters to home ownership and an increased difficulty in getting adequate rents from lower income renters.¹⁵⁹ Rent levels in general have been insufficient to sustain and stimulate investment in residential rental property.¹⁶⁰ To meet the nation's projected needs for rental housing, changes are needed in the rental housing market.¹⁶¹

Further achievement and maintenance of our national goal of providing an adequate living environment for all Americans will require a coordinated federal and state effort. A national policy in support of rental housing, a policy that must respond to what some in government have called a crisis in our nation's rental housing market, cannot be fully effective as long as states and local communities can promulgate a vast array of legislation that creates disincentives for private investment in residential rental property.¹⁶² Rent

Laurel decisions is the questionable assumption that it is economically feasible to build new housing for lower income people; if new housing is built, however, a trickle-down effect may help lower income people); HOUSING SUPPLY AND AFFORDABILITY, *supra* note 2, at 199-201 (evaluating inclusions housing programs).

¹⁵⁶ REPORT, *supra* note 1, at 59.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* See also U.S. GEN. ACCOUNTING OFFICE, RENTAL HOUSING, *supra* note 16, at i-iii.

¹⁵⁹ REPORT, *supra* note 1, at 59.

¹⁶⁰ *Id.*

¹⁶¹ *Id.* at 59-60. See also U.S. GEN. ACCOUNTING OFFICE, RENTAL HOUSING, *supra* note 16, at 29-30.

Our Nation's rental housing market has reached a crisis stage creating particularly bleak prospects for lower income renters

Although the Government is subsidizing a significant number of rental units, the need for additional assistance far exceeds the Government's present ability to provide it

The Congress and HUD are faced with quite a challenge — how to encourage private investment in rental housing which is affordable to the majority of the renter population. Without private involvement, our Nation will be farther away from achieving its 1949 goal of providing a home in a suitable living environment for all American families within their financial means.

Id. at 29.

¹⁶² See U.S. GEN. ACCOUNTING OFFICE, RENTAL HOUSING, *supra* note 16, at 29. See also *U.S. Home Ownership Declines*, Wall St. J., Apr. 2, 1984, at 1, col. 3. The share of households owning their own homes dropped to 64.6 percent in 1983 from 65.6 percent in 1980. Analysts have cited housing costs as the major factor in this decline. A 1 percent decline represents over half the gain made in home ownership during the 1970s. *Id.*

controls and other state and local regulations, although responsive to large numbers of voting tenants, are not responsive to the need to stimulate private investment in residential rental property. As a result, current tenants benefit from below market level rents, while future tenants suffer from the resulting shortfall in supply. Consequently, state and local legislation is often in direct conflict with the national needs for maintaining and improving the rental housing stock.

B. *Non-Local Impact of Local Rental Housing Policy*

Under our federal system, states retain the power to regulate many aspects of the rental housing market.¹⁶³ Some states have also enabled local communities to exercise a portion of this legislative power with respect to rental housing.¹⁶⁴ Because the sources of rental housing regulation are diverse, multiple policies are at play.¹⁶⁵ This multiplicity of policies regarding rental housing works against a coherent national policy.

The primary focus of state and local regulation is the balancing of the rights and interests of landlords and tenants. In the process, such regulations also strike a balance between renters and homeowners, at least by implication. The impact of rental housing regulations on investment by potential landlords will have at least secondary effects on home ownership as people compare the costs, comforts, and availability of rental housing to the alternative of home ownership. Regardless of how these balances are struck, strong political and popular support appears to exist for allowing the decision to be made and implemented at the state and local levels.

Although state and local decisionmaking in the rental housing market may appeal to the "homespun" American ideals of direct participation in government, it has a markedly negative effect from a national perspective. The decision, for example, by New York City voters and legislators to protect current tenants from "unfair" rents means that, to the extent it creates a disincentive for investment and reduces the supply of rental housing stock, tenants who might otherwise live within New York City will have to live in New Jersey, Connecticut, or elsewhere in New York State. Rent control in one area not only affects where people live, but also creates a need for additional highway facilities for commuting and, therefore, adds to traffic noise and air pollution on an intercommunity and interstate basis. The local decision to regulate rents, then, affects surrounding communities and states.

More significant and less obvious is the way people from other communities and states are required indirectly to subsidize policy decisions made by local communities elsewhere for the benefit of their own residents. Federal revenue sharing programs, urban and state grant programs, and tax incentives make such subsidies possible.¹⁶⁶ State and local governments know that the federal government will make funds available to

¹⁶³ See *supra* notes 52-155 and accompanying text for a discussion of state policy and regulations on rental housing.

¹⁶⁴ See *supra* notes 52-124 and accompanying text for a discussion of rent control and building codes implemented at local level.

¹⁶⁵ See *supra* notes 60, 94, 96, 109, 110, 111-15.

¹⁶⁶ See M. FRIEDMAN & R. FRIEDMAN, *supra* note 14, at 109-12 (rather than help the people needing homes, most subsidy programs have really only benefited the landowners, builders, and sellers); Olsen, *Housing Programs and the Forgotten Taxpayer*, 66 THE PUBLIC INTEREST 97, 102-08 (1982) (a short history of United States housing policy) [hereinafter cited as Olsen]. See also REPORT, *supra* note 1, at 27-48, for a discussion of the Community Development Block Grant Program and public housing assistance.

alleviate their "rental housing crisis," rejuvenate their dilapidated rental housing stock, or create tax incentives to offset local disincentives to invest in residential rental property. New York City, for example, can impose rent controls, enact overly restrictive zoning, prevent conversions, and otherwise establish disincentives for investing in rental housing, while offsetting many of the adverse consequences to the availability of rental housing through federal intervention.

The federal government has two basic ways of generating funds to assist state and local governments with housing problems.¹⁶⁷ It can either raise revenue through taxes or it can increase the money supply.¹⁶⁸ Through taxes, revenues raised from the entire national populace can be redirected to any given local market. In this manner all taxpayers pay for tax incentives provided for investors in residential rental property. To the extent that a state or local government can shift these incentives away from federally targeted recipients through regulation, federal policy is frustrated and localities are allocating tax-based funds. This shift of incentives can occur when state and local regulations are of the type discussed in this article that cause disincentives for investment in residential rental property, which can be counter-productive to federal tax incentives to encourage such investment. Through revenue sharing programs too, the federal government can shift tax revenues from one state to another. This method in effect causes one state to subsidize the rental housing policy of another.

State and local decisions on rental housing policy, therefore, are of national interest and have a national impact. Under the current system of federal intervention, residents of states without restrictive rental housing regulations subsidize restrictive anti-investment policies in other communities and states. In many cases, the policies they are subsidizing indirectly may be the same policies considered and rejected directly by their own legislators or by Congress. In effect, local regulation is being used to reallocate federal revenues among the states. While this situation has the political advantage of giving more power to the states, it makes the implementation of the national policy favoring provision of adequate and affordable housing for all citizens difficult and endangers the maintenance of an adequate supply of rental housing.

V. RECOMMENDATIONS

The need for a coherent national housing policy requires action to correct current market misallocations and inefficiencies. These misallocations and inefficiencies are the product of conflicting federal, state, and local housing policies. To correct this situation this article recommends three major areas of change: (1) the coordination of a national policy on rental housing through a system of federally legislated incentives and disincentives; (2) the creation of a voucher system of subsidies for moderate income tenants; and (3) the reformation of portions of the federal tax code affecting investment in housing.

¹⁶⁷ M. FRIEDMAN & R. FRIEDMAN, *supra* note 14, at 253-70. In addition to raising taxes or printing money, the government can also enter the financial markets to borrow from the public. In so doing, it must offer interest payments to investors that must be included as part of the national debt. This increased interest puts additional pressure on the government to attempt to offset the debt by increasing taxes or printing money. *Id.*

¹⁶⁸ *Id.*

A. *Federal Coordination of Rental Housing Policy*

The nation's rental housing stock is currently in a state of crisis.¹⁶⁹ This condition cannot be corrected so long as our national problems stem from divergent regional and local policies, and the indirect effects of these policies transcend their arbitrary geopolitical boundaries. The federal government must take the lead in formulating and implementing a national policy on rental housing that will solve this problem by coordinating local decisions with macroeconomic effects. A solution will not be possible, however, so long as the federal role is limited to passive intervention and subsidies.

To ensure proper political and fiscal responsibility at the state and local level, the federal government should not provide unlimited cross-subsidies and local housing "crisis" bailouts. State and local decisions, in a world of limited resources, must be made and priorities established on the basis of a reasoned evaluation of housing policies as they affect private investment in rental housing, free of unlimited federal assistance. These decisions should consider not only short-term benefits to renters, but also the long-term need to maintain an adequate supply of rental housing stock. This approach would require state and local authorities to evaluate the alleged benefits of all housing regulations in light of the actual unsubsidized cost of programs in both the short-term and long-term. In the absence of an outright prohibition on state and local regulation of rental housing the decision process should at least internalize the true cost of local regulatory actions. In this manner, state and local authorities could still implement regulations inconsistent with the national goals, if deemed essential to local needs, but would do so on the basis of an economically rational decision process, with the full cost of such regulation being borne by the local community to be benefited.

Equally important is the need to recognize that local solutions cannot be fashioned at the expense of national difficulties. The decision to subsidize renters indirectly at the expense of landlords and the creation of incentives for divestment of rental housing by landlords is nationally unacceptable. Housing is not simply a local concern, but a national priority.¹⁷⁰

Federal coordination of national housing policy should seek, through legal and economic incentives and disincentives, to make state and local policy consistent with national needs and objectives. This system of incentives and disincentives can be analogous to the approach used in implementing a maximum highway speed limit of 55 miles per hour, and in encouraging a national minimum drinking age of 21 years.¹⁷¹ A system of this kind recognizes that federal funds are limited and in the area of rental housing, resources used to subsidize construction, create tax incentives, or issue local grants should be apportioned to reward state and local governments that cooperate in furthering national policies on rental housing. This approach would, in the long run, ensure an *adequate* and *affordable* supply of rental housing. Federal coordination requires only that the federal government disburse direct and indirect housing assistance to state and local authorities in accordance with their compliance with national rental housing objectives. The federal government could reduce or eliminate federal grants, revenue sharing, and financial assistance to localities that impose regulations such as rent control, anti-

¹⁶⁹ U.S. GEN. ACCOUNTING OFFICE, RENTAL HOUSING, *supra* note 16, at 29.

¹⁷⁰ National Hous. Act of 1937, ch. 121, 50 Stat. 70, 70-71 (1937) (current version at 12 U.S.C. § 1703 (1982)).

¹⁷¹ 23 U.S.C. § 154 (1982) (55 miles per hour provisions); 23 U.S.C. § 158 (1984) (21 year old drinking age provisions).

conversion provisions, and overly restrictive landlord and tenant and land use regulations.

Scarce federal resources are not effectively used where local regulations offset nationally subsidized programs and incentives for construction and maintenance of rental housing.¹⁷² Therefore, federal funds should be directed to those localities that provide a complementary system of regulation that establishes a process for incentives for private investment in rental housing rather than a specific agenda for special interest legislation that hinders investment and requires federal subsidies just to maintain the status quo.

B. A Voucher System of Subsidies

Emphasis on encouraging private investment in rental housing requires a willingness to allow rents to rise. As rents are allowed to rise and regulation is streamlined, normal market forces should attract new investment into residential rental property ownership.¹⁷³ Market forces would bring about a far more efficient allocation of scarce resources within the various segments of the housing market and would allow rental housing to be more competitive with alternative investment opportunities. A rise in rents, however, will not be without adverse effects on moderate income citizens who are caught between the inability to afford home ownership and the increasing cost of rental housing. Being above the "low income" mark, these people do not have access to the safety net of programs for subsidized low-income housing projects.¹⁷⁴ To alleviate the hardship that may fall upon this group of moderate income people, a system must be implemented to subsidize individual needs for adequate affordable shelter in rental housing, without penalizing the long-term supply of rental housing. Such a system should address individual needs, rather than group needs. The form of subsidy should therefore be geared not towards subsidized housing projects, but to individual assistance through modified cash vouchers.¹⁷⁵

A voucher system would be similar to the system used for food stamps; vouchers would be distributed to qualified people for use towards the purchase of rental housing. Because tax dollars would support the voucher subsidy, the cash outlay should not be totally unrestricted. The voucher subsidy should be targeted, and redeemable for only qualified rental housing. Qualified rental units could be identified on the basis of general guidelines for structural soundness, lack of rent controls, nondiscriminatory rental practices, and other reasonable qualifications. As long as approval of rental housing for participation in the voucher program were not arbitrarily restricted, multiple sources of rental housing would be available to tenants. Within this general program, moderate income tenants would have a choice of landlords and rental housing facilities. Competi-

¹⁷² See REPORT, *supra* note 1, at 92-93.

¹⁷³ A. DOWNS, *supra* note 53, at 2-5 (rents and profitability need to be increased to attract capital to the rental housing market).

¹⁷⁴ For the purpose of this proposal, moderate-income people are those individuals just above the cut-off for eligibility for low-income benefits — such as welfare or food stamps — up to the median income level of \$24,000. Basically, those earning sixty percent to 100 percent of the median income of \$24,000 (\$14,400 to \$24,000) should be considered moderate income people under our proposal.

¹⁷⁵ For a discussion of the application and benefits of a voucher system to improve educational services see M. FRIEDMAN, CAPITALISM AND FREEDOM 87-107 (reissued 1982) [hereinafter cited as M. FRIEDMAN]; M. FRIEDMAN & R. FRIEDMAN, *supra* note 14, at 158-75; F. HAYEK, 3 LAW, LEGISLATION AND LIBERTY: THE POLITICAL ORDER OF A FREE PEOPLE 60-62 (1979).

tion between landlords would continue to make terms, services, and facilities responsive to reasonable tenant preferences.¹⁷⁶

In administering the voucher system, guidelines for qualification for the subsidy would have to be developed.¹⁷⁷ Income ranges should be established relative to the average income in the local community. A possible range for "moderate" income might be from 60 percent to 100 percent of the average household income in the community. Within this range of qualified income a sliding scale subsidy could be established. Assuming similar circumstances, a larger subsidy should go to the "lower" income people or to families with more dependents.

The subsidy itself should be set at an amount sufficient to enable the recipient to rent adequate housing and the subsidy should progressively diminish to zero at the top end of the qualified income range. In establishing the incremental reduction in voucher subsidy, the system should be less than a dollar-per-dollar setoff against a recipient's increases in income to retain incentives for individuals to work for extra income.¹⁷⁸ Diminishing marginal returns would then exist for income gains within the qualified range but at least some incentives would be retained. In addition, a system would be established that is more favorable than one that would provide a full subsidy or no subsidy based on an arbitrary absolute dollar amount.

The voucher system is preferable to directly subsidized housing projects because it preserves individual choice in selecting rental housing, while allowing numerous private investor-landlords to compete for tenants. This system should provide for better service and facilities than if one landlord were providing housing for the entire subsidized group. In addition, the voucher system makes pluralistic housing more feasible, because subsidized and unsubsidized people could live in the same apartment complex much as food stamp recipients shop in the same grocery stores as nonrecipients.

A voucher system also ensures affordable housing without burdening landlords. Current state and local regulatory efforts instead ensure the affordability of rental housing by forcing landlords to accept lower or nonexistent profits. These regulations constitute, in effect, a tax on landlords for the benefit of tenants. As a tax, such regulation encourages divestment. The voucher system, on the other hand, maintains the affordability of rental housing without forcing landlords to subsidize renters. Instead, by drawing voucher funds from the general tax revenues of the federal government, all taxpayers bear the cost of the subsidy.

While a voucher system for housing has been proposed previously, it differs from the current proposal. The former proposal benefited low-income and elderly families and

¹⁷⁶ See HOUSING URBAN AMERICA 242-44 (J. Pynoos, R. Schafer, & C. Hartman eds. 1980) (a competitive market will operate within a system using vouchers or certificates to subsidize rents).

¹⁷⁷ See M. FRIEDMAN, *supra* note 175, at 190-95 (the negative income tax proposals of Milton Friedman establish the proper method of providing aid to those in need of assistance while retaining some of the incentives important for a responsive market system); M. FRIEDMAN & R. FRIEDMAN, *supra* note 14, at 124-46 (more on the negative income tax methodology); Olsen, *supra* note 166, at 99-102 (discussing a method of giving tax subsidies to individuals in need of assistance). See also Pub. L. No. 98-369 § 612, 98 Stat. 905 (1984) (Tax Act of 1984 provides for a tax offset voucher-like system under provisions for mortgage credit certificates).

¹⁷⁸ See generally M. FRIEDMAN, *supra* note 175, at 190-95; M. FRIEDMAN & R. FRIEDMAN, *supra* note 14, at 124-26. In both books, Friedman makes a similar argument in the context of a proposed negative income tax. His argument seems readily applicable to the system for voucher subsidies proposed here.

served as a substitute for present forms of housing subsidy.¹⁷⁹ In the structure proposed here, the voucher system is *not* a substitute for existing federal subsidy programs but a complement to them. It is, however, a substitute for existing state and local housing regulations.

Earlier experiences with voucher programs for low income tenants have had mixed results, but in general they have demonstrated an ability to benefit national housing policy goals.¹⁸⁰ Under the current administration, the Department of Housing and Urban Development (HUD) is again experimenting with a voucher system for subsidizing low income tenants.¹⁸¹ The focus of this article, while advocating a voucher system, is not to address low income housing problems that have given rise to prior programs,¹⁸² but to expand on present housing policy. The voucher system proposed here is designed to give financial aid only to those moderate- or lower-middle-income people who, as a result of change in rental housing regulations, are unable to afford either rental housing or home ownership. Many of the people unable to enter the home-ownership market without the federal tax subsidy provided through the home mortgage interest deduction should nonetheless be able to afford rental housing and would therefore be ineligible for any voucher subsidies.¹⁸³ Likewise, to the degree that limited numbers of moderate- or lower-middle-income people need a voucher subsidy, federal tax revenues generated by the reduction or elimination of the currently projected 255.8 billion dollar subsidy for home ownership for the fiscal years 1984-1989 could provide the funds for the subsidy.¹⁸⁴

The extent of the federal tax subsidy for home ownership can be put into perspective by looking at the number of voucher-subsidized housing units that could be built for a

¹⁷⁹ By focusing on moderate-income people, the authors are in no way rejecting the idea of a voucher system for low-income renters or anyone else. To the contrary, a voucher system for low-income people, in addition to moderate income people, may be a better alternative than most current forms of subsidy. A voucher system is the best way to alleviate the hardship caused by rising rents and an increased demand for rental housing — both of which can result from reduced state regulation and reduced subsidies to homeowners. For comments on a recent Reagan administration voucher plan for the poor, see J. Lubin, *Shrinking Shelter-Declining Housing Aid Worsens the Struggle for Many Poor People*, Wall St. J., Aug. 31, 1984, at 1, col. 1.

¹⁸⁰ Frieden and Walter, *What Have We Learned From the Housing Allowance Experiment?*, 50 M.I.T. — HARV. JT. CENTER FOR URB. STUD., Working Paper No. 62, at 2, 47 (1980).

The results certainly did not bear out the skeptics' fears of widespread inflation and unavailability of housing. Contrary to their predictions, the hard-to-house were able to find adequate housing through the allowance program or had already found reasonable places earlier. Female-headed and welfare families especially were able to make good use of housing allowances

Housing allowance proponents can take satisfaction in the program's ability to reach and help families with serious housing problems. The high turnout of welfare families underlines the failure of existing transfer programs to provide adequately for the necessities of life and suggests that housing payments fill an important gap in the network of social assistance.

Id. at 47.

¹⁸¹ [1984 Current Developments] HOUS. & DEV. REP. (BNA) 183.

¹⁸² See, B. Frieden & A. Walter, *What Have We Learned From The Housing Allowance Experiment?* 50 M.I.T. - HARV. JT. CENTER FOR URB. STUD., Working Paper No. 62 (1980); [1984 Current Developments] HOUS. & DEV. REP. (BNA) 183.

¹⁸³ 18 LAND USE DIGEST, January 15, 1985, at 3. The \$255.8 billion federal tax subsidy to homeownership consists of \$185.3 billion for the home mortgage interest deduction and \$70.55 billion for the state and local property tax deduction as projected for fiscal years 1984-89. *Id.*

¹⁸⁴ *Id.*

similar cost. Under the current HUD voucher subsidy program for low-income housing, HUD has budgeted 86.5 million dollars to cover 4,543 units.¹⁸⁵ This amounts to an estimated \$19,040.28 per unit. Reallocation of the 255.8 billion dollar subsidy for home ownership to the rental market would provide 13,434,676 units at the same per-unit subsidy for the fiscal years 1984-1989 for moderate-income families. When considered in this light, it seems that a system of voucher subsidies can be put in place to assist people facing financial hardship as a result of reducing or eliminating regulations that create disincentives for investment in rental housing.

The implementation of a federally funded and administered voucher system for moderate- or lower-middle-income families would keep the benefits of state and local regulatory schemes intact, but would remove the serious difficulties inherent in such schemes. A federal voucher system would create no disincentive to ownership of rental housing, and state and local governmental units could no longer subsidize their own populations at the expense of others. In short, the voucher system would protect rental housing, ensure its affordability, and maintain a nationally consistent housing policy.

C. Federal Tax Changes

There are problems, however, in funding a new federal subsidy to help moderate-income families obtain affordable rental housing. A voucher system of housing assistance payments for moderate-income households would be a relatively costly program, whose costs would necessarily be borne by taxpayers.

The federal government could take two basic approaches. First, it could simply choose to spread these costs among all taxpayers by enacting a general tax increase. The difficulties with such a plan, however, are that it would be politically difficult to achieve and would imply a preference for such a subsidy over all other subsidies taxpayers might pay.¹⁸⁶ To increase the overall subsidy to housing and to fund it through a general tax increase would, inevitably, lead other interest groups, such as industry and education, to demand that new revenues be used for their favored activities, rather than for housing.

An alternative to a general tax increase, coupled with an implied decision to give a *greater* subsidy to rental housing than currently exists is simply to leave unchanged or even reduce the total value of the present subsidy in absolute dollar terms, but to shift priorities and targets within the general subsidy provided for housing. To accomplish this change, of course, would require that some part of the existing subsidy be eliminated or reduced.

A cogent argument can be made for increasing the subsidy for rental housing at the expense of the subsidy for single family home ownership.¹⁸⁷ While the dream of home ownership has been an integral part of the American ideal for the last century, it is a dream that cannot be realized in a world of increasing population and a growing scarcity of resources. On efficiency and social policy grounds, the maintenance of a subsidy for single-family home ownership is impractical. Under present law, low-income families receive a direct subsidy for rental housing, and higher-income families receive an indirect tax subsidy through the deduction for mortgage interest for single-family home ownership. If this indirect interest subsidy were reduced or eliminated, some of those individuals who currently can afford to own a home would be precluded from home ownership.

¹⁸⁵ [1984 Current Developments] HOUS. & DEV. REP. (BNA) 183.

¹⁸⁶ The authors do not argue for such a preference.

¹⁸⁷ See *supra* notes 13-19 and accompanying text.

These people, therefore, would be forced to live in rental housing which, presumably, they could afford without a subsidy. By reducing the indirect tax subsidy for home ownership, however, funds would become available for subsidizing moderate income families who, under the present system of subsidies, could not fully afford market level rents. In effect, by reducing the subsidy to marginal income home owners, money could be made available to aid marginal income renters. The subsidy "safety net" now provided primarily to elderly and low-income families would be extended to protect moderate-income families as well.

As past attempts at reduction of the mortgage interest deduction have demonstrated, this proposal will encounter serious political opposition. A careful review, however, could justify it. The voucher proposal would entail no overall increase in housing subsidy funds. On the contrary, it would be possible to lower the overall amount of the federal subsidy to housing. Furthermore, although the shift from subsidizing home ownership to subsidizing rental housing would force into apartments some families that otherwise might be able to purchase housing, the shift would give far greater housing opportunities to families that now must either struggle to afford adequate rental housing or depend upon artificially maintained rent levels through state controls. Most important, however, by funding the proposed rental housing voucher system, this subsidy shift would make it possible for the federal government to justify legislation designed to encourage states *not* to enact or maintain burdensome regulations. Ultimately, the rental voucher system would eliminate the need for such controls. Thus, although homeowners and potential homeowners would be adversely affected, this result would be offset by the advantage to renters.

Mechanically, this subsidy shift could be accomplished through legislative amendments made to section 163 of the Internal Revenue Code. The type of amendment would determine upon whom the burden of the reduced home ownership subsidy would fall. The easiest amendment to effect and implement would be one that simply limited the amount of deductible interest as expressed by a percentage of *total* interest paid. Thus, such an amendment would specify that only a stated percentage of interest paid for financing a principal residence would be deductible.

This form of legislative change presents problems; it falls most harshly on lower-income homeowners and does not reduce the deductibility of interest paid to maintain second homes. Politically, therefore, it would seem to be necessary to add two other provisions to this amendment. First, only interest paid on debt acquired to purchase a *principal* residence should be deductible. Mortgage interest on second homes, therefore, would be non-deductible. Second, a cap should be imposed on the total amount of mortgage interest that can be deducted. This cap would be determined by reference to the average cost of a single family residence and by the average cost of financing such a house. Interest paid over the cap would be non-deductible. Thus, the suggested amendment that would be most equitable and would also raise sufficient revenues to fund adequately the proposed rental voucher program would be one that capped deductible interest, limited interest deductions for residential mortgages to mortgages on *principal* residences, and reduced on a percentage basis the amount of such interest that would be deductible overall.

VI. CONCLUSION

American housing policy is currently in a state of disarray. Federal policies generally support both rental and owner-occupied housing. The federal government now uses both

direct and indirect subsidies to further these policies. At the same time, many state and local governments have also enunciated a policy favoring the provision and maintenance of adequate and affordable rental housing. Various state and local governments have implemented these policies primarily through enactment of regulations concerning rent level, zoning, habitability standards, and eviction controls. Unfortunately, these regulations are tantamount to a tax upon potential and actual landlords and, therefore, create disincentives to invest in multi-family rental housing. State and local regulations are therefore in conflict with federal policies. Consequently, a host of problems arises.

An additional factor that contributes to the current state of American housing policy is the emphasis the federal government has placed on owner-occupied housing since the end of the second world war. Owner-occupied housing suffers from a number of serious drawbacks. It is financially inefficient, encompassing both a tax shelter component and an investment component, and it seems to lend itself to higher, more costly owner expectations as to amenities. Most Americans simply cannot afford to own their own homes. Furthermore, it is inappropriate for government to subsidize owner-occupied housing to the degree that it currently does. While owning one's own home is part of the American dream, dreams must occasionally be altered to conform with reality. In a world where the total number of subsidy dollars is limited, government should not subsidize the investment component in owner-occupied housing, nor should it create incentives for inefficient tax shelters.

The proposals set forth in this article are realistic. While the proposals will undoubtedly give rise to political controversy if implemented, they are well-justified. First, enacting federal legislation designed to eliminate or control state and local regulation of housing is vital to the continued availability of residential rental housing. Only by eliminating the disincentives to investment created by current regulations can federal policies favoring an adequate stock of rental housing be assured throughout the United States. Second, to ensure that this housing is affordable, and to replace the former state and local regulations designed to achieve affordability, the federal government should initiate a new voucher program, targeted at families of moderate means to help them procure satisfactory rental housing at an acceptable price.

Unfortunately, such a voucher program will be costly. The authors believe that additional federal subsidies to housing above the present level are politically unfeasible and could be challenged on policy grounds. Too many other social needs compete for taxes. Therefore, to fund the proposed new voucher program without increasing the overall level of the federal housing subsidy, funds within the housing area will need to be reallocated. The best way to accomplish this reallocation is to reduce the indirect tax subsidy for home ownership and shunt the savings from this reduction to the proposed voucher program. This reduction would *not* affect low- and moderate-income homeowners. On the contrary, it would only affect households desiring to purchase either second homes or homes costing above the median. This allocation would affect these households only as to interest paid or funds used to purchase these excess assets. While this reduction in the tax subsidy does create a disincentive to certain forms of home ownership, it also creates a major subsidy program for much more needy families. On this basis, it is justifiable.

If we lived in the best of all possible worlds, one of unlimited wealth and resources, the proposals contained in this article would be unnecessary. Everyone could own his or her own home. Unfortunately, we live in an imperfect world of scarce resources. Allocative choices must be made. This article suggests the direction such choices should take.

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