

Brief Economic Analysis of the Proposed Increase in the Business License Tax on Residential Rental Property in Berkeley, California

Prepared for Councilmembers Laurie Capitelli and Jesse Arreguin

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Summary

Berkeley is part of a regional housing market in which rents have increased far beyond what is economically necessary to profitably operate and maintain rental housing. Rents are increasing due to increasing demand for the limited supply of rental housing located in the central Bay Area. The increasing value a location in Berkeley, as in the rest of the central Bay Area, is created by the surrounding community and the larger society, not by the rental property owners. The public is entitled to recapture this socially created value to use for public benefit rather than allowing it all to be taken for private profit.

Berkeley tenants are now paying \$100 million a year over and above the rent that would be necessary to provide landlords with a fair return on their investment and as a result the value of rental property in Berkeley has increased by well over \$1 billion. There has been only modest reinvestment in building renovations and most owners are shielded from increased property taxes because the property remains at its pre-vacancy decontrol valuation until sold.

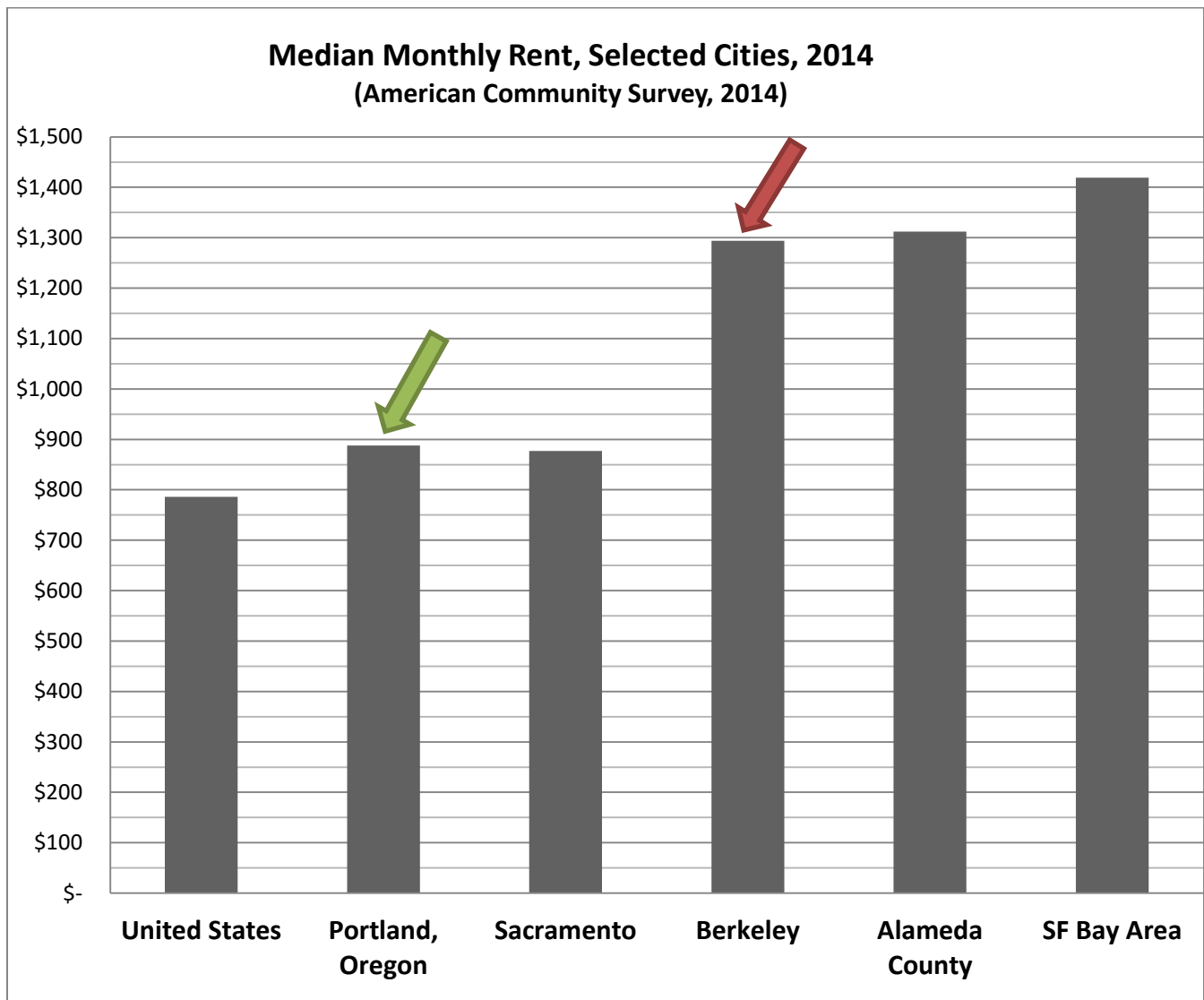
An increase in the business license tax on Berkeley's residential rental properties would recapture part of the excess rent and allow the City to use that revenue for community benefit. The tax increase would not be passed on to the tenants. Most current tenants are protected by rent stabilization. The rent in exempt buildings and for vacant units is and will continue to be set at the maximum the market will bear regardless of whether there is a modest increase in the tax on gross receipts.

Certain types of property and certain owners should be exempt from the increase: apartments occupied by "old rent control" tenants, where rent increases have been limited to the rate of inflation; "inclusionary" apartments covered by regulatory agreements that keep their rents permanently affordable; and apartments owned by current small, low or moderate income landlords. To encourage development of additional rental housing, there should be a 10 year exemption for new construction. An exemption could also encourage landlords to rent to tenants with Section 8 and similar housing assistance vouchers.

I. Overview of the Bay Area Rental Housing Market

Berkeley's affordable housing crisis is part of the larger Bay Area affordable housing crisis. Figure 1 below shows Bay Area and Berkeley median rents are dramatically higher than median rents in the U.S. as a whole; much higher than median rents in Portland, Oregon, a Pacific Coast city known for its high quality of life; and much higher than in Sacramento.

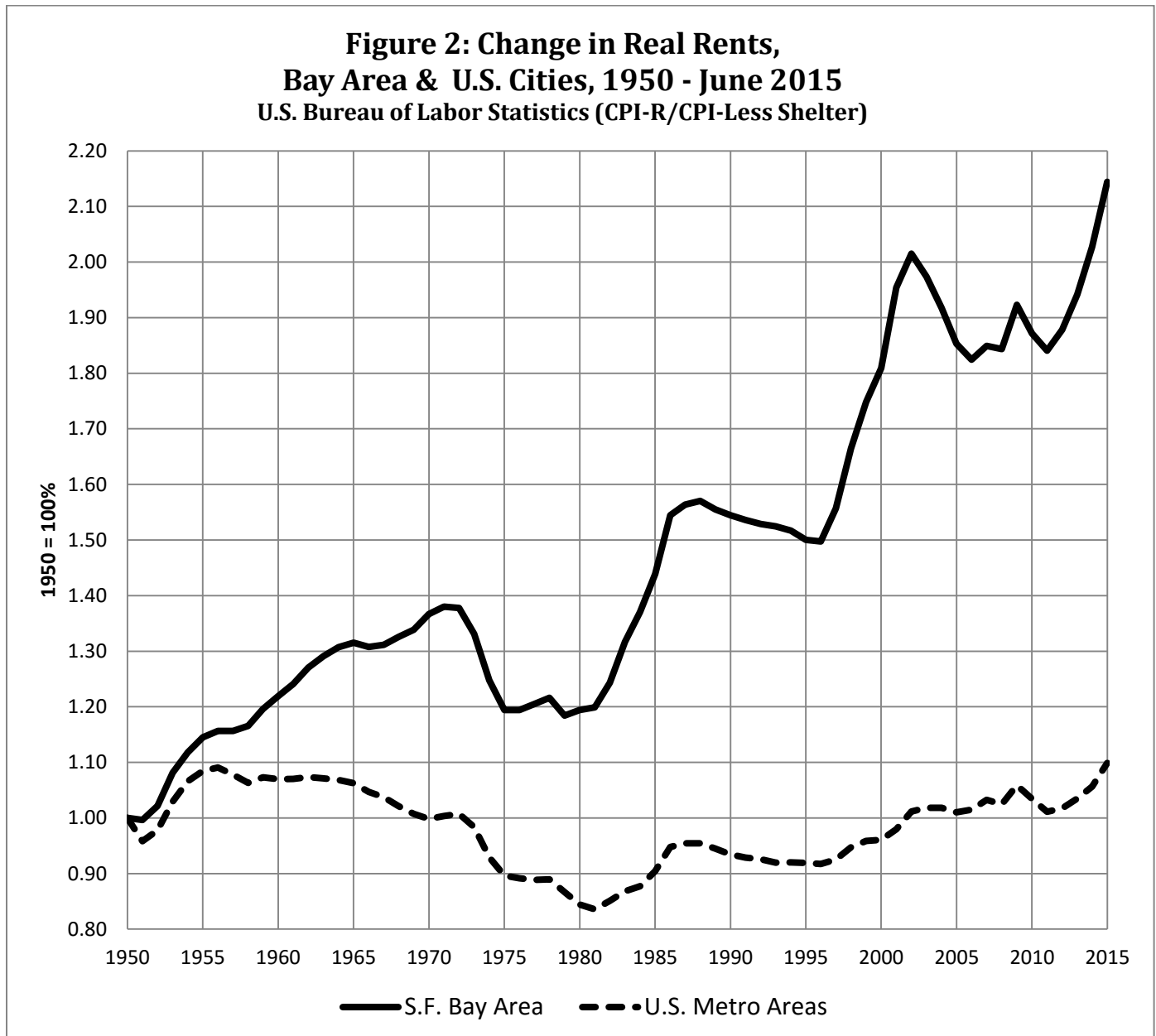
Figure 1: The Bay Area is a High Rent Regional Housing Market



Berkeley's rents are slightly below the average for the nine-county San Francisco Bay Area, but Berkeley has smaller rental units than the Bay Area as a whole, and this accounts for most of the difference. (Note that Census data on median rents is for all rental units, including subsidized

housing. The higher average rents typically reported in the newspapers are based on industry surveys of market rate housing, mostly in larger and newer apartment buildings.)

The Bay Area's rents have been increasing faster than rents in most of the rest of the United States for quite a long time. Figure 2 below shows the trend in "real" rents, meaning residential rents adjusted for inflation.



Overall U.S. rents have been a model of stability compared with the San Francisco Bay Area. Rents in most of the U.S. declined in the period from after World War II until 1980, rose gradually until 2011 and have risen unusually rapidly since then. Since 1980 the Bay Area has

seen two roughly fifteen year-long cycles, with five or six years of rapid rent increases followed by a period of stability lasting about ten years. We are now several years into a third period of rapid rent increases. Berkeley's strong rent controls shielded the city from the effects of the first round of increases that began in 1979, but vacancy decontrol went into effect in time for the second round of major increases that began in 1996 and market rents reached extraordinary levels during the dot.com boom.

Rents for the Bay Area apartments do not need to be as high as they are in order to profitably operate and maintain them. Figure 3 below shows that even before the latest run-up in rents, the net operating income (income after paying operating expenses, usually abbreviated NOI) for East Bay apartments was well above the national average, as well as above the average for the comparison cities of Portland and Sacramento.

Figure 3: High Rents Are Not Economically Necessary



Operating expenses were somewhat higher in the East Bay, largely because the higher NOI increases the value of rental property and this increases property taxes after the property is sold.

Another indication that Bay Area rents are higher than necessary is a comparison with the cost of running non-profit housing. Satellite Affordable Housing estimates that its monthly costs, which include operating and maintenance expenses, resident services and, in place of NOI, a reserve set-aside for future renovations, typically range from \$550 to \$750 a month depending on the size and condition of the building and the nature of the residents served.¹

It is clear that Bay Area rents are far above what is necessary to profitably operate and maintain older housing where construction costs were paid off years ago. Standard economic theory tells us that in a fully competitive market, rents would be the minimum necessary to profitably operate and maintain rental housing. Clearly, the Bay Area rental housing market is far from a fully competitive market.

¹ Communication from Susan Friedland, Executive Director, Satellite Affordable Housing Associates, Sept. 14 and Oct. 1, 2015

II. Bay Area Rents: High Demand, Constrained Supply

The Bay Area has high and growing demand for housing because it is a very desirable place to live. It combines great natural beauty, a diverse and tolerant population, a creative culture, decent to high quality public services and a strong regional economy. The Berkeley economy is anchored by the University of California, which has substantially increased both its student population and its staff. All of these factors are mutually reinforcing. The natural beauty of the area is protected by public park systems and water districts. The strong regional economy is usually considered the immediate driver of high demand, but was itself generated by the area's creative and tolerant culture and diverse population and is sustained by heavy public investments in transportation systems, educational systems and so on.

While demand is growing, the supply of housing is seriously constrained. First, the Bay, the ocean and the hills limit the land available to build on. If we draw a circle around downtown San Francisco showing a 50 mile commute radius, three quarters of that circle is either under water or on steep hills where it is not economically feasible to build at high densities. Second, redeveloping urbanized land at higher densities is substantially more costly and takes much longer than building on large open areas on the suburban fringe. Most of the remaining land suitable for building apartments is already developed at low densities. The costs of demolition and site preparation, the costs of building upwards at higher densities and the costs of constructing a unique building designed specifically for the site all mean that development of new, in-fill rental housing is only profitable when rents rise to fairly high levels. Finally, land use regulations generally favor single-family homes over apartments and further reduce the land available for development of additional rental housing.

It is sometimes argued that the solution is simply to eliminate restrictive land use regulations and let the "free market" work. This ignores the major role of the first two factors, limited buildable land and the high costs of in-fill redevelopment. The California Legislative Analyst's Office estimated the additional housing that would have been needed to keep increases in California housing costs at the national average from 1980 to 2010. Alameda County would have needed another 400,000 housing units in addition to its current 590,000 units.² Berkeley's proportionate share would be an additional 33,000 units. A higher but realistic rate of new housing production would make an important contribution but could only moderate the rate of increase rather than return rents to more affordable levels.

These three factors – limited buildable land, the high costs of in-fill redevelopment and restrictive land use regulations – mean that the Bay Area housing market is unable to fully respond to increases in the demand for housing. As a result, instead of rental property owners competing for tenants by holding down rents to the lowest practical level, tenants compete for

² Taylor, Mac, *California's High Housing Costs: Causes and Consequences*, Legislative Analyst's Office, March 17, 2015, p.22

rentals located in the Bay Area, especially locations in the central Bay Area such as Berkeley. This means that rents are set based on tenants' willingness and ability to pay rather than on the minimum socially necessary cost of building, operating and maintaining rental housing.³

In Berkeley then, as in the Bay Area generally, a large part of the rent is simply an “admission charge” for privilege of living here in this location. The value of location is well understood in the real estate industry. There is a long-standing real estate cliché to the effect that the three most important factors determining whether real estate will go up in value are “location, location and location”. Increases in the rent that people will pay for a location are particularly profitable because they require little, if any, additional investment by the owner.

Economists usually refer to the value of a location as land value. The land value of a rental property is determined by the amount of rent tenants will pay above and beyond what is necessary for the profitable operation and maintenance of a building, an amount called land rent or ground rent. (“The rent of a house may be distinguished into two parts, of which the one may very properly be called the Building rent; the other is commonly called the Ground rent.” Adam Smith, *The Wealth of Nations*, 1776) This is an example of what economists call “economic rent”, the general term for business revenue that comes from ownership of something scarce, above and beyond the revenue that is actually necessary for businesses to produce goods or services in a fully competitive market.

The value of a location in Berkeley comes from public investment, public services, its creative and diverse culture, the livability of the community, the University of California, which continues to increase its student body and staff, and the growing Bay Area economy. Together these factors make Berkeley a highly desirable place to live and all of these factors are the creation of the public, the larger society. The moral foundation of a market economy is the idea that people are rewarded for their own economic contribution. Profits made from the contributions of others deprive them of the value they created. **The public is entitled to regulate or recapture the value the public has created instead of allowing real estate investors to take it all for private profit.**

Berkeley has already acted on this principle through two major public policies: strong rent control, which existed from 1979 to 1998; and requirements that developers of new, for-profit housing provide community benefits such as “inclusionary” units or affordable housing fees.

From 1974 until 2009 Berkeley used “inclusionary zoning” to require developers of multifamily housing to make 20% of the project affordable to “low-income” people (with incomes at 80% of area median). When application of this requirement to rental property was struck down by the courts in the *Palmer* decision, Berkeley shifted to a requirement that developers mitigate the indirect economic effects of the new housing by either paying fees into the City’s Housing Trust

³ Barton, Stephen, “Land Rent and Housing Policy: A Case Study of the San Francisco Bay Area Rental Housing Market”, *American Journal of Economics and Sociology*, Oct. 2011, 70:4, 845 – 873.

Fund or by making a certain number of apartments in the project affordable to “very low-income” tenants (with incomes at 50% of area median). Other community benefits required of new development have included support for childcare, open space, cultural event spaces and transportation system improvements.

Since developers know in advance what they will be required to contribute, they can reduce the amount they pay for the site by enough to ensure that the development will remain profitable. (The potential value of such community requirements is limited by the willingness of landowners to sell sites at prices the developer are willing to pay.) This type of policy is often called “land value recapture” because the community recaptures part of the value of the location; a value created by the community and not by the land owner, to use for community benefit. The City of Berkeley is currently discussing the appropriate level of affordable housing requirements for new development. Based on the most recent nexus study, the City has the ability to set requirements at or even beyond the maximum level under which development is economically feasible.

While using “land value recapture” with new development, for existing rental housing the City has used rent regulation. From 1979 to 1998 Berkeley used strong rent control to hold rent increases to the amount necessary to provide a constitutionally required “fair rate of return” to rental property owners. This prevented rent increases based solely on the increasing demand for Berkeley as a location, while allowing rent increases that were necessary to profitably operate and maintain the buildings and for capital improvements. After vacancy decontrol was imposed by the State in 1999, however, rent stabilization could no longer prevent increases in land rents and owners of existing rental housing now obtain most of the potential profits from rising demand for Berkeley as a location (see Figure 4, below).

Rent stabilization continues to serve the valuable purpose of slowing down increases and preventing displacement, currently widespread elsewhere in the Bay Area. It does not provide long-term affordability, except for the roughly 2,500 remaining “old rent control” tenants whose units have never had a vacancy increase. Many of these tenants are elderly or disabled and their numbers are slowly diminishing. In light of vacancy decontrol and the major resulting increases in Berkeley rents, the City should consider recapturing part of the community-created value of a Berkeley location for existing residential rental property.

III. The Berkeley Rental Housing Market

Figure 4 below compares the median stabilized rent with what the rent would have been if it had simply increased at the same rate as inflation as measured by the consumer price index. In the first decade of strong rent control rents did not keep up with inflation. After election of a Rent Board majority more sympathetic to landlords in December 1990 rents were increased faster than the rate of inflation. The State mandated partial vacancy decontrol from 1996 – 1998, which allowed rents to rise faster than inflation, and with full vacancy decontrol in 1999 rents soared. Vacancy decontrol coincided with the dot.com boom, which fueled a major increase in market rents in Berkeley and throughout the Bay Area.

Figure 4: Berkeley Rents Have Increased Much Faster Than Inflation

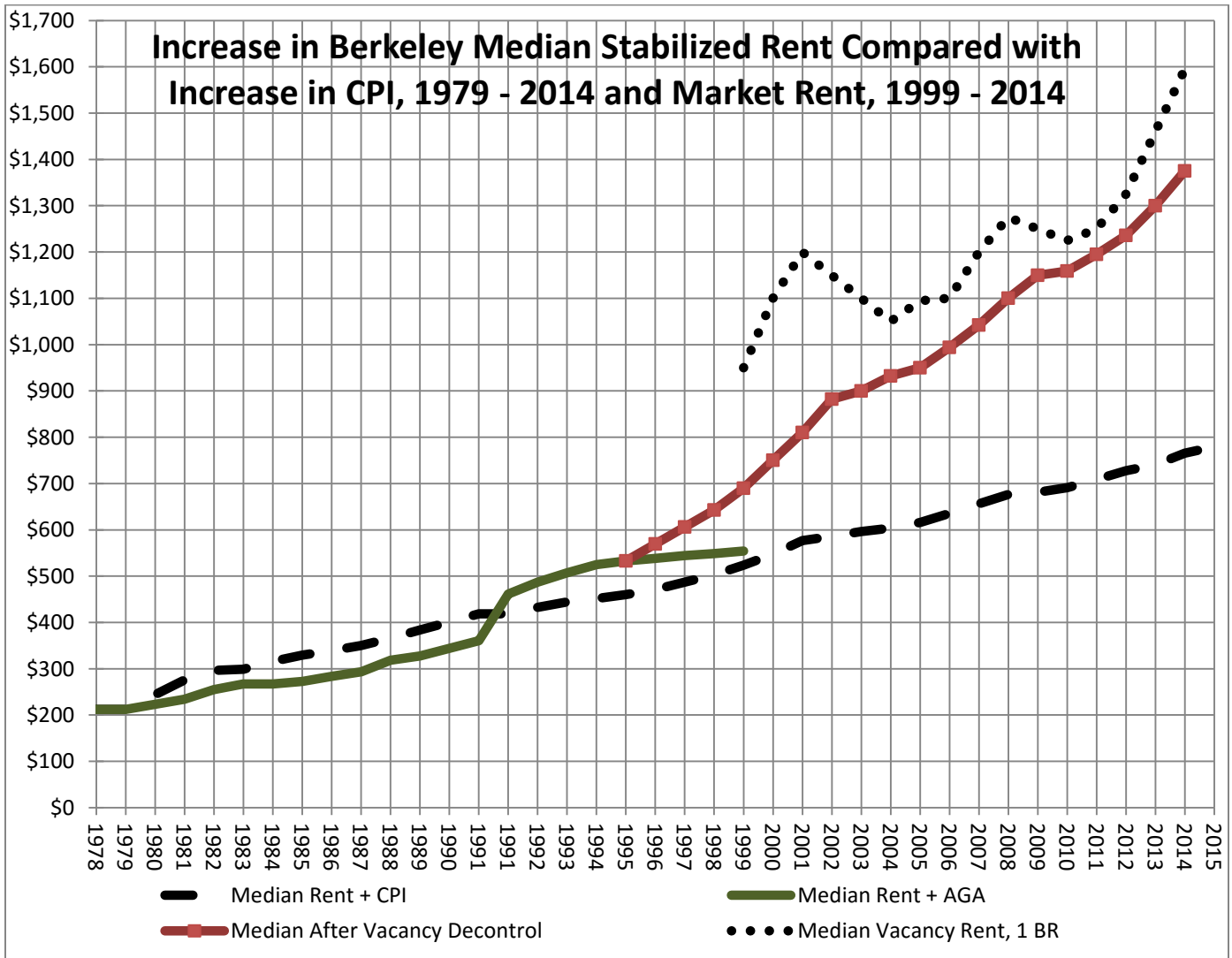


Figure 4 also shows current market rents reported for vacant one-bedroom apartments, starting with vacancy decontrol in 1999. It took several years for the majority of Berkeley rental units to turn over and receive a vacancy increase, bringing the overall median rent close to current market levels. In recent years the median Berkeley rent has lagged the current market by two or three years. As noted above, vacancy decontrol slows the speed of increases and reduces displacement, but does not maintain long-term affordability.

Annual rents for 19,000 rent stabilized apartments are up from \$164 million in 1998 (\$720 mean monthly rent) to \$342 million in 2014 (\$1,498 mean monthly rent).⁴ Some of this increase was necessary to compensate for the effects of inflation on operating costs and net operating income, but having more than doubled, **2014 rents are more than \$100 million a year over and above the inflation adjustment necessary to provide owners with a fair return on their investment, a massive transfer of income from renters to real estate investors.**

Some of this increased rent is reinvested in the community, either through building renovations or through increased taxes. The amount of reinvestment was examined in two reports by the Rent Stabilization Board.⁵ These reports reviewed the valuation of work done under building permits taken out for Berkeley residential rental properties and found that less than 1% of the total rent is being reinvested. Looking specifically at the increased rents received from vacancy decontrol, on average 4.7% of the increase was reinvested in the buildings, with 1.5% for seismic work in a small number of buildings and 3.2% for all other work. This assumes that all work done under permit is renovation, which is considered reinvestment, rather than maintenance, which is considered an operating expense. Even assuming that work done under permit represents only half or one third of actual renovation work, the rate of reinvestment in rental properties is only a small fraction of the increased rent.

The Rent Board reports also reviewed the increased property taxes paid due to increased property values from recent sales and from the City's business license tax on and found that owners were paying approximately 4% of the "excess" rent in increased taxes. Two-thirds of Berkeley's rental properties still have assessed valuations from before vacancy decontrol, saving the owners an estimated \$11 million annually in reduced property taxes. Even making generous assumptions about the amount of renovation done without permits, it is clear that only a small fraction of the increased rent is going back into the community.

Rental property values are typically based on Net Operating Income (NOI). Well over \$90 million of the additional \$100 million in increased rent goes to NOI. (Taxes are an operating expense but renovations are considered an investment expense.) Applying a conservative

⁴ Berkeley Rent Stabilization Board, "Market Medians: January 1999 through December 2014", March 11, 2015

⁵ Berkeley Rent Stabilization Board, *Rent Stabilization, Vacancy Decontrol and Reinvestment in Rental Property in Berkeley, California*, June 18, 2012; *Effects of Rent Stabilization and Vacancy Decontrol on Rents, Rental Property Values and Rent Burdens in Berkeley, California*, April 19, 2010.

capitalization rate of 7.5%, the additional NOI increases the value of Berkeley's rent stabilized residential rental properties by \$1.2 billion. Applying a more reasonable 6% capitalization rate yields an increase in property value of \$1.5 billion. Overall then, **investors in Berkeley rental properties have gained \$1.2 to \$1.5 billion in increased property values.**

It is important to note that these rent increases do not mean that all landlords are making high profits. No matter how high the rents, some investors will speculate on future rent increases and pay so much for a property that after paying the mortgage(s) they have a low or even negative cash flow. Indeed, the market for investment properties is biased in favor of this kind of investment, because it is the buyer with the most optimistic assumptions who will outbid other prospective buyers. Economists refer to this as "the winner's curse", because the high bidder is the one most likely to overpay for an investment property. Similarly, some long-term owners take out profits by borrowing against the increased value of a property, often to buy more properties, and borrow so much that they have a low or even negative cash flow after paying the mortgage(s).

As rents go higher, the cycle continues. New investors pay even more for rental housing, long-term owners borrow more to buy more property. They often argue that they are having difficulty maintaining their properties and that government should reduce regulations and taxes to accommodate their problematic investment decisions. **No matter how high the rents, some investors will make risky, speculative and just plain bad business decisions and lose money as a result.** Nonetheless, it is clear that rents in Berkeley are far in excess of the level necessary to profitably operate and maintain rental housing and far in excess of what rents would be if the regional housing market operated under fully competitive conditions.

IV. Proposed Tax Increase and Exemptions

Berkeley currently has a business license tax of 1.081% of the gross rent that applies to residential rental properties with 3 or more units and currently brings in approximately \$3.5 million a year. On July 14, 2015 Councilmembers Capitelli and Arreguin co-sponsored a request that the City consider increasing this tax in a range from 1.8% to 3.8%, but with a number of recommended exemptions. Here I will first consider the proposed tax increases in light of recent trends in rents and then review the proposed exemptions.

Each 1% increase in tax would cost owners an average of \$16 per unit per month or \$192 per unit annually and, with no exemptions, increase the City's revenue by approximately \$3.3 million annually. With all of the exemptions discussed below, each 1% would likely increase revenue by around \$2.5 million. From December 2012 to December 2014 the average rent for rent stabilized units in Berkeley rose by 11.4% and the upward trend is expected to continue for some time.⁶ Even if market rents level off in another year or two, the average rent in Berkeley will continue to increase as longer-term tenants move and the rents for these units catch up to the current market rates. Adjusted for inflation the 11.4% increase over the last two years is an 8.4% increase in real rent. The lowest suggested tax increase in the Council item under consideration (1.8% of gross rent, averaging about \$30 per unit per month) is one-fifth of the amount that rents have increased over and above the rate of inflation in just the past two years. The highest proposed increase (3.8% of gross receipts, averaging about \$60 per unit per month) is still less than half of the two year increase over inflation. The lowest proposed increase would likely increase City revenue by \$4.5 million annually and the highest by \$9.5 million annually, rising as rents increased and as units moved out of exempt status.

The tax increase would not be passed on to tenants. The vast majority of tenants in properties with three units or more are in apartments covered by rent stabilization, which does not allow pass-through of costs unless the owner can demonstrate that it is necessary in order to receive a fair return on their investment. This will rarely be the case for properties where most units have received a vacancy increase and, as suggested below, units occupied by "old rent control" tenants should be exempt.

Even in post-1980 buildings not subject to rent stabilization and at the time new tenants move into rent stabilized units at market rents, owners could not further increase the rent to pass the added cost on to the tenants. As discussed above, in a market with high demand and constrained supply, rents are limited more by tenants' ability to pay than by market competition. Only in a fully competitive market, where rents are held to the minimum necessary to profitably operate and maintain the building, will increases in costs be passed on to tenants. Similarly, in a fully competitive market, reductions in cost would be passed on to tenants in reductions in rent. The

⁶ Rent Stabilization Board, "Market Medians: January 1999 through December 2014", March 11, 2015

idea that Bay Area rents are determined by operating costs has already been tested following the passage of Proposition 13 in 1978. Proponents promised tenants that a reduction in property taxes for landlords would lead to reductions in rent for tenants. Instead, rents continued to rise, as would be expected in a market characterized by high demand and constrained supply.

As we have seen, Berkeley rents are far above the necessary minimum. Owners raise rents to market levels that are governed by tenants' willingness and ability to pay rather than by the buildings' operating and maintenance costs. Owners may claim they would pass the increased tax on to their tenants in the form of rent increases, but they would normally increase the rent by the same amount anyway. Landlords can only pass on the cost of the tax if they customarily charge a below-market rent and do not already, as a regular practice, increase rents as the market allows. There is no evidence that owners are systematically charging rents lower than what the market will bear. Instead, rents are normally set based on the upper limit allowed by the continually rising market. In this case the tax will inherently come out of the additional net operating income landlords are receiving as a result of the increasing demand for rental housing located in Berkeley. In effect, it would serve as a "windfall profits" tax on Berkeley's high and rising rents.

Based on the structure of the tax and the rationale for the increase, there should be exemptions for certain categories of owners and rental units.

- One and two unit rental properties and non-profit housing are fully exempt from the business license tax under the current ordinance and would not be affected by the increase.
- "Inclusionary" and "density bonus" units have regulatory agreements with the City making them affordable to people at specified income levels, some for 55 years and others permanently, and rents do not rise with the market.
- "Old rent control" units with pre-1999 tenants still have rents limited to what is necessary for a fair return and are not yet generating windfall profits based on rising demand for housing in Berkeley.
- Current small low and moderate-income landlords. This might be defined as landlords owning less than 10 or 15 units and with annual incomes under the area median income, which is currently \$74,800 for two people and \$93,500 for a family of four.
- Hardship exemptions, criteria to be set by City Council, would allow consideration of exceptional cases.
- In order to encourage development of additional housing, new construction should be temporarily exempt for 10 – 20 years after certificate of occupancy.
- Consider exempting units occupied by tenants receiving monthly rental assistance through the Housing Authority or the City to encourage landlords to rent to them.

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U.S. Bureau of the Census, American Community Survey

U.S. Department of Labor, Consumer Price Index

About the Author

Dr. Stephen Barton holds a Ph.D. in City & Regional Planning from the University of California, Berkeley. He is the co-author of *Common Interest Communities: Private Governments and the Public Interest* and author of numerous articles on housing policy and economics published in academic and professional journals, one of which received a National Planning Award from the American Planning Association. He served as Director of the Housing Department and as Deputy Director of the Rent Stabilization Program in Berkeley and received a Distinguished Leadership Award from the Non-Profit Housing Association of Northern California for his work with the City. Now retired, he serves on the Board of the Bay Area Community Land Trust and on the Berkeley Committee of East Bay Housing Organizations.