Rent Control and the Theory of Efficient Regulation

Richard A. Epstein

Follow this and additional works at: https://chicagounbound.uchicago.edu/journal_articles

Part of the Law Commons

Recommended Citation

This Article is brought to you for free and open access by the Faculty Scholarship at Chicago Unbound. It has been accepted for inclusion in Journal Articles by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.
RENT CONTROL AND THE THEORY OF EFFICIENT REGULATION

Richard A. Epstein*

My introduction to rent control took place before I entered law school, reflected upon the role of private property in a democratic society, or learned about theories of efficient regulation. It came in 1963, during my senior year at Columbia College when I was in search of an off-campus apartment. My original quest turned up a lovely four room apartment on 111th Street and Amsterdam Avenue, ideal for me and my prospective roommate, and a steal at $125 per month. I saw the unit but then was unable to get the superintendent to reach the building owner to close the deal. Later I was told by a wise graduate student that my naiveté was the source of my undoing. The superintendent “needed to have his palm smeared” in order to make the appropriate connection. Someone else more savvy in the ways of New York City had made the necessary side payment.

Still, I was not totally defeated in my quest to escape dormitory living, because lucky circumstance is often a fit substitute for the wisdom of the streets. My parents’ next door neighbor in the suburbs happened to own an apartment building near the college. He just had a vacancy when an elderly couple finally relinquished their rent controlled apartment to move south to Florida. The former tenants rented in 1943 for about $58.00 and that figure, with one 15 percent increase in 1953, was still the rent when, deep into retirement, they vacated in 1963. New York’s rent control law at that time allowed the landlord a 15 percent increase with a change in tenant, so my lease was for approximately $75.00.1 The favorable lease did not fall my way

* James Parker Hall Distinguished Service Professor of Law, University of Chicago. Columbia College, A.B., 1964; Oxford University, B.A., 1966; Yale Law School, LL.B., 1968. Stuart Sterk gave valuable comments on an earlier draft of this paper. I should like to thank Sean Smith for his usual able research assistance in preparing this article.

1 For popular accounts of the New York City laws, see Kristof, The Effects of Rent Control and Rent Stabilization in New York City, in RENT CONTROL: MYTH AND REALITIES 125 (The Fraser Inst. ed. 1981) [hereinafter RENT CONTROL]; Olsen, Questions and Some Answers About Rent Control: An Empirical Analysis of New York’s Experience,
simply as an act of neighborly benevolence. I had plans to leave town upon graduation, and then my landlord-neighbor could obtain another increase, hopefully from another student, until the rent equalled the market rent on an identical unit four stories above my own — $175.00.

These two incidents, occurring back to back, diverted my attention from the history of ancient philosophy and made me pause to think about all the oddities, favoritism, intrigue, and corruption of New York’s system of rent control. I had an uneasy sense that something was very much awry, but I had little, if any, sense of the intellectual wellsprings of my discomfort. I think it is fair to say that intellectual views are shaped (not justified, but shaped) by one’s early experiences, and mine had clearly predisposed me to be skeptical towards rent control. Now, twenty-five years later, my skepticism has ripened into overt hostility. I shall therefore take this occasion to voice my objections to the rent control system of which I was once a lucky beneficiary.

In order to make clear these developments, this Article is divided into four parts. The first part argues that all rent control statutes, regardless of their peculiar features and structures, are per se unconstitutional under the takings clause of the Constitution. The second part contrasts my analysis of rent control with the received judicial interpretation. The third part explains why the constitutional rule embodies a theory of efficient regulation because it eliminates the distortions that otherwise arise from the systematic gap between regulated and market prices. The fourth part examines some of the communitarian justifications for rent control, and argues that, properly understood, these justifications are only disguised pleas for privilege and special interests.

I. CONSTITUTIONAL ANALYSIS OF RENT CONTROL STATUTES

Rent control statutes come in all types, shapes and sizes.\(^2\) In

\(^2\) For an exhaustive catalogue of all the variations, see Baar, *Guidelines for Drafting Rent Control Laws: Lessons of a Decade*, 35 Rutgers L. Rev. 723 (1983), which contains references to most of the statutory materials, cases and law review literature prior to 1983. Baar’s paper assumes the soundness of some system of rent control, and then addresses the practical problems of drafting, interpreting, and applying such systems.
some instances the law pegs the allowable rent to historic rents for the unit at some base time. Rent increases may then be allowed upon a change in ownership of the apartment unit, upon the completion of certain necessary improvements, upon some formula that reflects the increasing costs of maintenance and repair, upon some general rule that is tied to the consumer price index or any other neutral yardstick, or even upon proof of tenant or landlord hardship. To understand the actual operation of any given rent control statute, it is critical to note the ways in which the permitted rents are computed. Rent control statutes are not all equally good, or rather, bad. New York’s rent stabilization is less of a disaster than the 1942 New York rent control statute. The responsible lawyer or economic analyst will try to draw relevant distinctions between them.

At this stage, however, I do not want to stress the differences among rent control systems, but their similarities. Indeed, the particulars on rental calculations do more to mislead than to inform. In this instance, unity does come out of diversity: a clear grasp of the basic analytics of the situation helps explain why it is the imposition of controls, and not the form of that imposition, that brands all rent control statutes as per se unconstitutional, notwithstanding a uniform line of cases that holds to the contrary.3

The most obvious way to proceed is perhaps through the takings clause, which provides, “nor shall private property be taken for public use, without just compensation.”4 As I understand it, the eminent domain clause raises three questions explicitly, and a fourth by necessary implication: first, has private

---

3 See, e.g., Pennell v. City of San Jose, 42 Cal. 3d 365, 721 P.2d 1111, 228 Cal. Rptr. 726 (1988), aff’d, 108 S. Ct. 849 (1988). For the early cases, see e.g., Block v. Hirsh, 256 U.S. 135 (1921); Marcus Brown Holding Co. v. Feldman, 256 U.S. 170 (1921). Note that there were four dissenters in both Block and Marcus Feldman. For a recent variation on the traditional theme, see Flynn v. City of Cambridge, 383 Mass. 152, 418 N.E.2d 335 (1981), which sustained the power of the state to prevent the removal of housing units from the rental market, whether by sale or for owner occupation.

property been taken; second, has that taking been for public use; third, has just compensation been provided for the property so taken; and last, is that taking justified under the police power. There is no mention of the police power at all in the Constitution. It must be read into the text by implication—without simultaneously reading out the explicit protections against uncompensated takings contained in the Constitution.

Starting with the first question, I take it as given that any fee simple absolute in possession can be divided into its constituent parts by grant or devise. A lease, like a life estate and a mortgage, is one of the limited estates that can be carved out of the fee simple, and it is an ordinary property interest, in fact, one of the older estates in land. The lease differs from the fee simple in that it is always created by grant or devise, and never acquired by initial or adverse possession. The leasehold interest is therefore born of the contract and conveyance that gives shape to its terms. For most leases these contract terms take on considerable heft. For example, the contract will specify duration, renewal options, assignability, and the duties on each side. In the world without rent control, the parties regulate some of these questions by express agreement; others are regulated by the set of default provisions created by the law. The rent, like the price in a contract of sale, is one term which is almost always set by agreement, without which an executory contract for a future lease is too indefinite to be enforced. The duration of the lease is also a term that is virtually always subject to specific negotiations.

Rent control statutes operate to take part of the landlord’s interest in his reversion and to transfer it to the tenant. In the typical case they do so by compelling the landlord, usually in the context of a lease renewal, to convey an additional term of years for the benefit of the tenant, at a price determined by the state, typically through a specific administrative board or housing court established for the purpose. That renewed lease is an in-

---

6 I bypass the serious problems of using specialized tribunals to pass upon questions of law and fact. The danger is that the members of the board will be chosen because they are champions of one side or another. The moderation that comes from having to select judges to pass on a wide range of issues is wholly lost, and the risk of ordinary bias, itself a procedural due process issue, is great. The problem has surfaced in connection with the first amendment, where specialized censorship boards pose a greater risk to artistic freedom than do general courts. See Near v. Minnesota, 283 U.S. 697 (1931), which struck
Rent control statutes do not, of course, isolate particular units for special treatment, but tend to apply to some broad class of cases, for example, all units rented to tenants as of January 1, 1942. No one would say that the eminent domain clause does not protect the ordinary owners if an entire district of a city is condemned. Likewise, forcing the mass renewal of leases by landlords alone only compounds the constitutional wrong of rent control. It hardly removes the governing regulation from constitutional scrutiny.

In response, it may be said that rent control statutes differ from the ordinary takings of property for two reasons. The state does not retain possession of the leasehold term for its own use through rent control, but directs by ordinance that the tenant use it for his own enjoyment. Similarly, the state does not pay any compensation at all, but instead directs the tenant to pay some set rent to the landlord. At one level, these two features seem to distinguish rent control from the paradigmatic taking of land for use as a public school, where the state both keeps the property and pays the compensation itself.

While these two grounds of distinction are present, they only make the use of state power more suspect. Viewed analytically, these differences are relevant not to the first question of whether property has been taken, but to the next two questions on the list — has property been taken for public use and has just compensation been provided. The first of these limitations is clearly offended by the standard rent control statute. The gen-

down a system of prior restraint in part because it was administered by a board. Blackstone's concern with licensure raises similar issues:

To subject the press to the restrictive power of a licenser, as was formerly done, both before and since the revolution [of 1688] is to subject all freedom of sentiment to the prejudices of one man, and make him the arbitrary and infallible judge of all controverted points in learning, religion, and government.

4 W. BLACKSTONE, COMMENTARIES *152.
eral sense of the public use limitation is that it prevents the taking of private property from A to give to B. Here A is the landlord, B is the tenant, and the leasehold term is the private property. The additional fact that distinguishes this from the ordinary taking is the constructive reconveyance of the property from the state to the tenant already in possession. Although the public use clause of the fifth amendment has been largely read out of the Constitution, this evasion should not reach the level of constitutional principle. The standard rent control statute gives the tenant the identical private ownership that any other tenant enjoys under an ordinary lease. There is the naked transfer from A to B that the Constitution prohibits, regardless of the details of the compensation system that is provided.

Let us suppose, however, what is clearly wrong, that the tenant's welfare is a "public use" (or perhaps an "indirect public benefit") that saves rent control statutes from this frontal public use challenge. Rent control statutes still flunk the test of just compensation, regardless of their details. Every rent control statute has only one raison d'etre — to insure that the landlord's rent is kept below the fair market rental of the property. The many variations in rent control formulae are of critical importance only if the inquiry is how to measure the difference between the market rental value and the regulated rental. Depending on the form, duration, and severity of the regulation, that differential can be either large, up to 80 or 90 percent of the market value of property in extreme cases, or small. But so what? The just compensation inquiry asks whether the landlord has been supplied with an equivalent in value to the lost property interest, so that the landlord is indifferent in economic terms between retaining the leasehold interest and the substitute compensation the state has provided.

If the state moved A out of a $100,000 house, it could not satisfy its constitutional obligation by paying A $60,000 in exchange: it would still owe $40,000. Now assume that this same house rented for $10,000 per year. The state cannot escape with paying A only $6,000. The state has short-changed the landlord $4,000 per year, even if the tenant's credit is impeccable. If the lease is renewable in perpetuity, then the shortfall over time be-
RENT CONTROL

comes the same $40,000 that it is with outright confiscation. The state's position is hardly made better because the landlord may look only to the tenant for compensation. Quite the opposite, this improper delegation of its own duty to compensate only throws the additional risk of tenant insolvency on the landlord instead of bearing it itself. Rent control statutes never provide just compensation to the landlord.

The case for the rent control statutes necessarily rests therefore upon the police power. Clearly there is some basis for incorporating this police power exception into the takings clause, just as some variation of it is incorporated into the first amendment ("clear and present danger") guarantee of freedom of speech. It is quite inconceivable to think that individuals could shoot the windows out of their neighbors' houses, or pollute either private or public waterways. But the rent control statutes are not directed towards private misconduct, or toward the amorphous concerns of public beautification, served by height and setback restrictions, or even towards the health and safety of tenants as a class. Even if we assume that the state police power reaches ventilation, sanitation, and fire prevention, it is still difficult to include the identity of the tenant, or the amount of rent paid to the landlord, within the health and safety category. The ritual incantation of the good ends served by these statutes ignores a realistic assessment of what rent control statutes do, or how they operate. How are health or safety im-


See, e.g., Welsh v. Swasey, 214 U.S. 91 (1909), relied on by Justice Holmes in Block v. Hirsh, 256 U.S. 135, 155 (1921). In Block, Justice Holmes stated: "These cases are enough to establish that a public exigency will justify the legislature in restricting property rights in land to a certain extent without compensation. But if, to answer one need, the legislature may limit height, to answer another it may limit rent." Id. at 156. Holmes misses the critical line between the control of externalities and the interference with contract. The state power is far greater in the former than in the latter. For discussion, see Epstein, Takings: Descent and Resurrection, 1987 Sup. Ct. Rev. 1, 10-11.

"Congress has stated the unquestionable embarrassment of Government and danger to the public health in the existing condition of things." Block, 256 U.S. at 156. The theme resurfaces in later cases: "The charter amendment includes in its stated purposes for imposing rent control the alleviation of the ill effects of the exploitation of a housing shortage by the charging of exorbitant rents to the detriment of public health and welfare of the city and particularly its underprivileged groups." Birkenfeld v. City of Berkeley, 17 Cal. 3d 129, 160, 550 P.2d 1001, 1023, 130 Cal. Rptr. 465, 487 (1976).
proved if the landlord is stripped of the financial resources that are necessary to comply with applicable health and safety regulations? More focused regulations, although themselves a possible subject of abuse, can deal with whatever health and safety problems are thought to exist in rental housing, while leaving rents free to move.

If safety and health will not save these statutes, what will? Justice Holmes argued that the statutes were justified, if only as a two-year temporary remedy, to avoid the congestion in Washington D.C. that resulted from the “sudden influx of people to Washington caused by the needs of Government and the war.” With Holmes’s formulation, the argument shifts from protection against private misconduct to the prevention of windfall gains as a result of a public necessity — the war. Even if this rationale is accepted, most modern rent control statutes would not come within it. But the rationale is itself defective because public necessity does not defeat the obligation to pay compensation. The problem of public necessity is an old one in the law of torts, as when government agents are forced to destroy private property to prevent the spread of a flood, or to resist an invading army. Whenever the property destroyed by the government would have been destroyed in any event, the claim for compensation is vanishingly small, not because the destruction was justified, but because the value of the property to its owner just prior to the taking was at best negligible. In some cases property is taken by the government in order to allow it to pursue its common ends. Public officials should not have to bear the full costs of those losses individually, for then they would be deprived of all incentives to provide needed public services. There is no rea-

---

11 Block, 256 U.S. at 157 (regulation giving a tenant the privilege of holding over after the expiration of the lease so long as he pays the rent and performs the conditions as fixed by the lease is not unconstitutional because it has a sufficient public interest).


13 See, e.g., United States v. Caltex, Inc., 344 U.S. 149 (1952), where the destruction of Caltex’s oil facilities in Manila before the Japanese takeover was not regarded as a compensable taking because the Japanese would have taken them in any case.

14 See R. Epstein, C. Gregory & H. Kalven, Jr., Cases and Materials on Torts 47-48 (4th ed. 1984), for a brief discussion of the mismatched incentives created by official
son why general taxes could not compensate those made to bear special losses. The eminent domain power allows the state, for example, to take lands for defensive installations, and supplies for troops. Therefore, even public necessity dictates both that the taking should occur, and that compensation should be provided, typically from general tax revenues.15

The necessity of citizens moving to Washington D.C. to aid in the war is small potatoes next to the usual public necessity case. In addition, the congestion would have taken care of itself in fairly short order. If rents had been allowed to rise, more units would have become available for renting, while the demands of tenants would have been scaled down. The return to equilibrium, moreover, need not be a long drawn out affair. Milton Friedman and George Stigler begin their entertaining 1946 attack on rent control by comparing the San Francisco housing market after the earthquake of 1906 with the same rental market after rent controls were imposed at the close of World War II.16 In 1906, there were apartments advertised for sale within a month after the earthquake, even though over one-half of the city's available housing stock had been reduced to rubble within a three-day period. Many people left the city for temporary shelters elsewhere, while spare rooms were let out to those who remained, and new construction began at a brisk pace. In 1946, the housing shortage said to justify rent control was below 10 percent, but under rent control the housing market was stagnant, with low vacancy rates.17 The moral is clear: congestion is a transitory phenomenon for which the regulatory cure is worse than the disease.

Even if congestion does give rise to a public necessity, it still only warrants the same response that is given in the core cases decided under the principle.18 The right response is a rental allowance to government employees, funded from general taxes.

---

15 For a discussion of this theme, see section III(A) infra.
17 These low rates are characteristic of rent control. For the modern evidence, see Tucker, Where do the Homeless Come From, Nat'l Rev., Sept. 25, 1987, at 32.
There is no justification for a system of comprehensive regulation that imposes the losses on a small fraction of the population. Rent control, in a word, does nothing to eliminate windfalls; indeed, without the rent control statute any current tenant gets a windfall for the unexpired term of the lease. In the short run rent control transfers windfalls from landlords to tenants, where neither side has any special claim to privilege.\(^{19}\) In the long run rent control perpetuates only these windfalls for a select class of lucky tenants.

II. THE CASE LAW

My analysis of rent control deviates sharply from the received wisdom on the subject, which gives the state wide latitude to impose rent control statutes. It should therefore prove of some value to examine the difference between my hard-edged approach and the law as it appears in the decided cases. The best place to begin is with the current law of rent control, in order to see how judges respond to the confiscation challenge. Here I wish to discuss only two important rent control decisions\(^{20}\) in detail: *Pennell v. City of San Jose*,\(^{21}\) which illustrates the anomalies that arise from efforts to work within the current constitutional framework; and *Hall v. City of Santa Barbara*,\(^{22}\) which illustrates the anomalies that arise from efforts to work around it.

In general, wide legislative discretion is not identical with the removal of all constitutional restraints on the process. A statute which provides for a $1.00 per month rent for all apartments would be struck down, even today, as confiscatory. Once some limitation on state power is recognized, it becomes necessary to identify which rent control statutes are permissible exer-

---

\(^{19}\) See section III infra.

\(^{20}\) I put aside the line of cases that are concerned with the relationship between state and federal power, most notably, *Fisher v. City of Berkeley*, 475 U.S. 1150 (1986), where the Court held that the Sherman Act did not preempt the Berkeley rent control ordinance. Note that the effort to find antitrust violations from the rent control statutes often postulate that the landlords have entered into conspiracies to restrict the maximum prices, against, of course, their own financial interest. The entire preemption issue is a diversion from the central questions of rent control.


\(^{22}\) 813 F.2d 198 (9th Cir. 1987), *aff'd*, 108 S. Ct. 1120 (1988).
cises of the police power and which are not. The answer is that the landlord should be entitled to a “just and reasonable return,” a term familiar from the law regulating natural monopolies such as public utilities. This was the standard since the first decision upholding rent control, *Block v. Hirsh*, and it has been reiterated in recent cases.

This intermediate standard is hardly secure because of the difficulty in finding the investment base on which the rate of return is calculated. If the original landlord, A, sells the reversion to B for three times the original cost, may B charge a higher set of rents than those allowable to A, even though the property has the same market value for both of them? It hardly makes sense to encourage an otherwise costly sale of real estate for the sole purpose of minimizing the effect of regulation. Yet just that is done whenever the regulatory rate of return is based on cost of acquisition, thereby ignoring the owner’s unrealized appreciation accruing between the time of original purchase and the onset of regulation. The Constitution, moreover, clearly requires this interim appreciation to be taken into account, because just compensation must reflect the market value, not original cost, both for the entire fee, and also for any partial interest carved out of it. The “just and reasonable return” standard does not afford the landlord fair compensation, and no system of regulated rents can allow a rent control statute to pass constitutional muster.

This position is strengthened by examining *Pennell v. City of San Jose*, a recent Supreme Court response to a rent control challenge. San Jose’s rent control statute allowed all landlords increases under one of three pricing systems: an automatic increase of 8 percent; an increase of 5 percent coupled with a pass through of certain specified costs; or, finally, an increase to help finance a mortgage on the regulated property. If dissatisfied with these formulas, the landlord could petition for an additional increase in rent “reasonable under the circumstances.” Among the

25 For further discussion, see R. Epstein, supra note 4, at 182-86.
relevant circumstances were financing costs, maintenance, service history, and — "the hardship to the tenant." This last element in the hopper was challenged as an improper ground for denying an increase otherwise warranted. The gist of the challenge was that "although the purpose to be advanced by the hardship provisions (providing financial assistance to poor tenants) is a proper one, that burden cannot be constitutionally placed on individual landlords who happen to have hardship tenants."\(^\text{27}\)

The California Supreme Court rejected this claim holding that the statute as a whole was not confiscatory given its minimum automatic 8 percent increase.\(^\text{28}\) The California Supreme Court added, "The possibility that local governments could accomplish the same result through a subsidy from general tax revenues has never been considered a bar to the validity of such legislation (on equal protection or any other ground) and we see no reason why such a possibility should operate to invalidate the limited reliance on economic hardship that is part of the ordinance under consideration here."\(^\text{29}\)

By a six-to-two vote, the United States Supreme Court affirmed in an opinion which can best be described as a judicial nonevent. Justice Rehnquist, speaking for the majority, first insisted that the case was not ripe for consideration since the offensive provision had never been applied in the particular case.\(^\text{30}\)

---

\(^\text{27}\) Id. at 371, 721 P.2d at 1115, 228 Cal. Rptr. at 730.

\(^\text{28}\) Id. at 373, 721 P.2d at 1117, 228 Cal. Rptr. at 732.

\(^\text{29}\) Id. at 372, 721 P.2d at 1116, 228 Cal. Rptr. at 731.

\(^\text{30}\) Pennell, 108 S. Ct. at 856. The argument here is simply wrong. Where there is a facial challenge to a statute, there should be no reason to wait until it has been misapplied in a particular case. That is certainly the view with respect to statutes that embody explicit racial classifications, and there is no reason for there to be any difference here, as Justice Scalia correctly notes in his pointed dissent. Id. at 860. The prematurity line is a transparent effort to squash constitutional challenges in takings cases. Such efforts have gained force since the unfortunate misreading of Pennsylvania Coal v. Mahon, 260 U.S. 393 (1922), by Justice Stevens in Keystone Bituminous Coal Ass'n v. DeBenedictis, 480 U.S. 470 (1987). In Pennsylvania Coal, Justice Holmes found that the Kohler Act was facially unconstitutional. He made such a finding despite the fact that only one owner would be affected by the challenged statute. The owner alleged that it would be impossible for him to profitably engage in his business. In Keystone, however, Justice Stevens rejected Justice Holmes's findings in Pennsylvania Coal. Justice Stevens concluded that since Keystone involved only a facial challenge without a similar complaint as in Pennsylvania Coal, it would be impossible to hold the statute unconstitutional. Further, the constitutionality of statutes cannot be determined except when a particular factual setting makes such a determination necessary. I have criticized this development in Ep-
He then reiterated his view that rent control, at least as a general matter, was unquestionably constitutional because its "asserted purpose" of "prevent[ing] excessive and unreasonable rent increases" caused by the "growing shortage of and increasing demand for housing in the City of San Jose" is a "legitimate exercise of appellees' police powers." The very conditions that rent control creates — shortages — is used to constitutionally justify the practice. The less said about so feeble an argument the better.

Justice Scalia's dissent incisively analyzed the political economy of rent control statutes. He began with the familiar "disproportionate impact" theme so crucial to assessing whether government takings are in fact compensated. As conventionally developed, the takings clause is "designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole." The objection to the San Jose scheme is that so long as public aid is a public function, it should be treated like a public function and discharged from general revenues; not inflicted upon landlords, or even cotenants, who just "happen" to house, or live in the same building as, the protected class of tenants.

---

31 Pennell, 108 S. Ct. at 857.
32 Id. at 862 (Scalia, J., dissenting).
33 See id. (quoting Armstrong v. United States, 364 U.S. 40, 49 (1960)). The phrase itself has seen the ebb and flow of judicial fortunes. It was largely buried by Justice Brennan in Penn Central Transp. Co. v. City New York, 438 U.S. 104 (1978), who claimed that "this Court, quite simply, has been unable to develop any 'set formula' to determine when 'justice and fairness' require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons." Id. at 123-24. However, it has been resurrected in Justice Scalia's majority opinion in Nollan v. California Coastal Comm'n, 107 S. Ct. 3141 (1987), in which the California Coastal Commission could not condition grant of permission to rebuild house on owner's transfer of public easement across property without paying compensation. Nollan is further discussed in Epstein, supra note 9, at 31-44.
34 Pennell, 108 S. Ct. at 864 (quoting Property Owners Ass'n v. Township of North Bergen, 74 N.J. 327, 339, 378 A.2d 25, 31 (1977)). In North Bergen, the statute in question limited the increases that could be charged to persons over sixty-five whose income fell below a certain level. The ordinance at issue provided that the landlord could recapture the foregone rents from either additional increases on unprotected tenants or from a general town subsidy. The court, however, thought that the general tax obligation could not be placed on either the landlord or the cotenants. The California Supreme Court in Pennell tried gallantly to distinguish the precedent, 42 Cal. 3d at 372-73 n.9, 721 P.2d at 1116-17 n.9, 228 Cal. Rptr. at 731-32 n.9, on the ground that the only defect in the statute was that it did not provide adequate assurance that the landlord could make the
As Justice Scalia pointedly noted, the rent control statute had important political consequences:

The politically attractive feature of regulation is not that it permits wealth transfers to be achieved that could not be achieved otherwise; but rather that it permits them to be achieved “off budget,” with relative invisibility and thus relative immunity from normal democratic processes. San Jose might, for example, have accomplished something like the result here by simply raising the real estate tax upon rental properties and using the additional revenues thus acquired to pay part of the rents of “hardship” tenants. It seems to me doubtful, however, whether the citizens of San Jose would allow funds in the municipal treasury, from wherever derived, to be distributed to a family of four with income as high as $32,400 a year — the generous maximum necessary to qualify automatically as a “hardship” tenant under the rental ordinance.  

There are two points of note in this passage. First, Scalia was clearly at pains to reconcile his rejection of the San Jose ordinance with his own belief that economic decisions are best entrusted to “normal democratic processes.” Scalia was able to effectuate his reconciliation only by giving the word “normal” normative as well as descriptive component. Descriptively, there is nothing more commonplace than having democratic processes generate systems of “off budget” financing. Most regulations are themselves disguised forms of taxation, designed to create the mismatch between the benefit and burdens of public programs. The point is clear with respect to rent control because the system of regulation, for example, allows local citizens to vote for programs, the costs of which are borne by nonlocal landlords. To say that off budget legislation is not part of normal political processes is to place a very powerful normative constraint on

recovery. But *North Bergen* was also concerned with the inequities of the burden when it observed that “when a landlord is entitled to additional rents, the initial burden falls exclusively upon the shoulders of the non-Senior Tenants who in a given case may be financially less capable of bearing the increase than the Senior Tenants.” *North Bergen*, 74 N.J. at 338, 378 A.2d at 30.

36 *Pennell*, 108 S. Ct. at 863 (Scalia, J., dissenting).

what legislatures can do and how they can behave.

Second, Scalia's approach cannot be confined to the objectionable "hardship" features of the San Jose law. His political-process objection to the San Jose ordinance applies to all forms of rent control — indeed to all forms of regulation generally.\footnote{For a discussion of the same point in connection with the funding of health and life insurance for AIDS victims, see Epstein, AIDS, Testing and the Workplace, 1988 U. Chi. Legal F. 33.} Rent control always involves at least an implicit subsidy of some tenants by some landlords. Even if tenants as a class are entitled to the subsidy, why should unwilling landlords alone provide it? If the state wants this program, it can use tax dollars to condemn buildings outright or build anew. The stock so acquired can then be leased to tenants at below-market rents. At that point the gap between the market value and the regulated value is brought "on budget," to be financed by tax revenues as Scalia's "normal" democratic processes require. Along with Scalia, I think that very few systems of rent control would be approved by voters if tax-funded financing were required across the board. Rent control is expensive, and public financing forces those who make the decisions to impose that system to also bear its costs. Only then do we get an honest revelation of the intensity of public preferences. This proportionate impact does more than distribute the costs of government programs. It has the desirable allocative consequence of reducing the frequency of undesirable government programs in the first instance. Scalia's single constraint on democratic politics has, I believe, an explicit basis in the takings clause. It also has the unintended capacity to transform the structure of modern takings law.

Hall v. City of Santa Barbara\footnote{813 F.2d 198 (9th Cir. 1987).} is a notable attempt to work around the received constitutional framework for rent control statutes. The Halls, owners of the Los Amigos Mobile Home Estates, sought to invalidate a 1984 Santa Barbara City ordinance that required the owners of mobile home parks to offer tenants leases on their spots for an unlimited duration. Under the mandatory leases, the tenant could terminate the lease at will, but the landlord could terminate only for cause as narrowly defined in the statute. The law also limited the landlord's annual rental increases over the indefinite leasehold term. Finally,
the ordinance allowed the tenant to sell the mobile home and simultaneously assign the lease on the same favorable terms the tenant had enjoyed. The complaint alleged that the value of mobile homes dramatically increased after the passage of the ordinance, because the tenant could now assign a valuable leasehold estate with the sale of the mobile home.

The statute in Hall is a manifest constitutional travesty. Before the imposition of the ordinance, the market value of the landlord's interest reflected the potential appreciation in the value of the plot after expiration of the lease. After the ordinance, the landlord was in effect demoted to a secured creditor whose rate of return, while variable, was strictly limited by the percentage increases allowable under the ordinance. The difference in value between the former equity and the present security interests determines the amount of compensation otherwise owing. The case law, however, required a very different treatment of the issue. If Hall had involved an ordinary apartment lease, the statute would pass muster if the statutory return met the elusive just and reasonable return standard.

In Hall, Judge Kozinski ingeniously invoked two arguments to show that this statute was special and thus escaped the constraints of existing case law. First, he relied upon the now standard, if largely unintelligible, Supreme Court distinction between those takings that involve permanent physical invasion of the property owner's land, and those that were mere regulations of use: the former are subject to far higher levels of scrutiny than the latter, and indeed are sometimes said to be compensable takings per se. Second, he noted that this rent control statute allowed the tenant to transfer unconditionally his leasehold, in contrast to the normal rent control statute that denies the tenant such free alienability. Neither distinction passes muster, but both illustrate the rickety nature of the present doctrinal structure.

The point of departure for Judge Kozinski's first argument was Loretto v. Teleprompter Manhattan CATV Corp. In this

---

Note that the deviation from existing case law prompted a motion for a rehearing in banc which was denied over three dissents. The dissent argued that ordinary rent control precedents governed this case. See id. at 209.

1982 decision, the Supreme Court held that the city had to pay compensation when it authorized Teleprompter to place its wires and switchboxes on private property without the consent of the owner. The court found there was a permanent physical invasion of the subject property. Although the invasion was trivial in the extreme, it triggered an automatic per se rule that demanded compensation. The stringent standard of Loretto thus contrasts sharply with the more relaxed standard of review applied when takings challenges are directed to "mere restrictions" upon use or development, found for example in the landmark preservation cases.\(^2\) Historically, the rent control cases have always been decided under the lower "mere regulation" standard. However, Judge Kozinski argued that the Loretto standard governed: the mobile home owner parked the vehicle on land owned by the mobile park owner, a clear physical invasion.

Unfortunately, every rent control statute contemplates a forced and complete occupation of the landlord's premises by an unwanted tenant, albeit not his mobile home. Indeed, if the statutes did provide for a transfer of possession to the tenants, then they could not be passed. A statute that simply set maximum allowable rents and permitted landlords to choose their tenants would still strip landlords of huge portions of their capital value in the apartment. But it would not transfer that wealth to the present tenants who supported passage of the statute. The landlord could relet the premises at the end of term to different tenants, so that the present tenants would in effect be using resources and votes to make gifts to strangers instead of transfers to themselves — an unlikely outcome given the politics of self-interest. The automatic renewal feature insures that the tenants capture the full gains of their legislative efforts by allowing them to maintain perpetual possession of the premises. It is an essential part of the political process. Yet mysteriously no cases have treated the tenant's occupation as the kind of permanent physical invasion that requires a high standard of review.

The root conceptual difficulty lies with the Supreme Court's insistence that certain incidents of ownership, that is, mere use and disposition,\(^3\) are in some way intrinsically less deserving of


\(^{13}\) See, e.g., Andrus v. Allard, 444 U.S. 51 (1979) (disposition of statutorily protected bird species); Goldblatt v. Town of Hempstead, 369 U.S. 590 (1962) (use of land prohib-
protection than others. *All* deprivations of property rights should be subject to the same standards of scrutiny. On the critical question of compensation, small takings may bring with them collateral benefits that leave the landowner better off than before, so that explicit cash compensation is not required. Yet by the same token, the "reasonable" rate of return in rent control cases is designed *not* to provide full compensation to the landlord, even when the full package of side benefits is taken into account. It is only when the takings side and the benefit side of the government action are blurred together that the familiar distinction between physical invasion and mere regulation looks plausible. But when the full effects of various government actions are unpacked — burden by burden, benefit by benefit — then the distinction between permanent physical invasion and mere regulation, on which Judge Kozinski built his *Hall* opinion, does not survive. *Hall* reaches the right result, but only because all rent control statutes are unconstitutional, not because this statute is any worse than the others.

A parallel analysis applies to Judge Kozinski's second purported distinction in *Hall*, the tenant's right to assign the lease. Most rent control statutes place implicit restrictions upon the ability of the lessee to assign his interest in exchange for cash or other valuable consideration. Removing this restriction simply makes explicit the total amount of uncompensated transfer that the rent control system works. The increased value of the leasehold interest is offset, if not exceeded, by a parallel loss in the value of the landlord's reversion. The tenant's assignment of the term only publicly ratifies what economic theory makes clear in any event. But why is the right to sell the tenant's interest intrinsically objectionable? Under the usual rent control scheme, the tenant is often reluctant to vacate the premises because he

---


45 In practice the total value of the property should drop. *See* note 46 *infra.*
then must sacrifice the valuable term to the landlord, while receiving nothing in exchange. The landlord may be willing to pay the tenant to regain possession of the premises. If the leasehold is not freely assignable, then there is a familiar bilateral monopoly situation where each side bargains for a larger share of the gains. Those bargaining problems are eliminated by a clear rule of tenant assignability, one that countenances an "efficient" once-and-for-all expropriation instead of a clumsy holdout problem on renegotiation.

Kozinski's opinion in *Hall* subjects this "efficient" form of confiscation to a higher standard of review than is imposed on the standard, inefficient, and clumsy forms of rent control. The present distinction may make some sense in that "efficient" confiscation rules may encourage the passage of more rent control schemes in the first place. But I suspect that no such functional reason accounts for the political decision to limit the tenant's right to assign the rent-controlled lease in a market transaction. Rent control is politically palatable and constitutionally allowable because it is a form of disguised confiscation. Once that confiscation is made explicit, the practice cannot survive criticism.\(^\text{46}\) When the tenant sells the landlord's reversion and pockets the landlord's money, the situation becomes clear enough for all to see. *Hall* embodies an unconstitutional rent control scheme, but no more so than any other.

III. INEFFICIENT REGULATION: THE GAP BETWEEN MARKET AND REGULATED RENT

In this section I want to pass beyond the constitutional issues to the social ones. In general, economists, unlike urban planners, are well nigh unanimous in their condemnation of rent

\(^{46}\) *See* R. Nozick, *Anarchy, State and Utopia* 270-71 (1974). Nozick makes the same point in explaining why subletting is normally not allowed for rent controlled apartments even though it improves the position of both the tenant and the subtenant without hurting that of the landlord:

So why do people find the subletting-allowed scheme unacceptable? It defect is that it makes explicit the partial expropriation of the owner. Why should the renter of the apartment get the extra money upon the apartment's being sublet, rather than the owner of the building? It is easier to ignore the question of why he should get the subsidy given him by the rent-control law, rather than this value's going to the owner of the building.

*Id.*
control statutes.\textsuperscript{47} The connection between those concerns and my takings analysis are far closer than might appear at first sight. The linkage is found in the just compensation theme that weaves itself through both the constitutional text and the economic measures of social welfare. In general economists have alternated between two standards: the Pareto standard of optimal efficiency and the potential compensation test.\textsuperscript{48}

The Pareto standard of efficiency\textsuperscript{49} requires that all persons in the new state of affairs be at least as well off as they were in the old state of affairs, with at least one person better off. The evaluations of whether someone is better or worse off rests on each individual's subjective evaluation of personal welfare, where it is taken as given that interpersonal comparisons of utility are not possible. Within this framework the actual payment of compensation allows the winners of certain legislative programs to buy off the losers with cash, leaving both groups better off than before. Applied to the rent control context, it means that cash payments from tenant to landlord will be necessary in order to insure that the tenant's gain does not result in any reduction in landlord welfare. Yet to state the proposition in that form indicates why rent control fails the Pareto test. The landlord is left worse off under rent control than without it. Ordinary contracts avoid this problem because they leave both sides better off, by their own subjective valuations.

In many circumstances, however, the actual payment of compensation might be regarded as difficult to execute, especially for widespread, comprehensive regulation. The rival Kaldor-Hicks,\textsuperscript{50} or potential compensation test, responds to these administrative problems. It stipulates that a legislative initiative is appropriate if the winners could hypothetically pay compensation to the losers in such amounts that both sides would regard themselves as better off from the initiative having

\textsuperscript{47} Frey, Pommerehne, Schneider & Gilbert, Consensus and Dissension Among Economists: An Empirical Inquiry, 74 AM. ECON. REV. 986 (1984), notes that fewer than 2 percent of the economists surveyed disagreed with the proposition that a "ceiling on rents reduces the quantity and quality of housing available." That figure represented the lowest level of disagreement on any point of policy.

\textsuperscript{48} For a general discussion, see Coleman, Efficiency, Utility, and Wealth Maximization, 8 HOFSTRA L. REV. 487 (1980).

\textsuperscript{49} Id. at 488.

\textsuperscript{50} Id. at 491.
been put into effect, even if the money is not actually paid. In essence this rule tolerates the one-sided gains to the tenants so long as they could have provided the landlords with sufficient cash transfers to make them better off under the regulation.

The Kaldor-Hicks formula is in obvious conflict with the Pareto standard. By removing a requirement for actual compensation, the Kaldor-Hicks formula works at cross purposes with the explicit language of the takings clause. All the important differences, practical and otherwise between the two standards,⁵¹ apply to the distribution of net social gains. If the prior distribution of benefits were 10 to 10, the Kaldor-Hicks formula would permit a statute that introduced a new distribution of 15 to 8. The Pareto standard would forbid this result but would tolerate a further expenditure of 1 in order to achieve, say a 12/12 or even an 11/13 split. Both standards, however, share one critical common feature: they categorically preclude changes which reduce the total stock of wealth (or utility) within the overall social system. If the winners gain less than the losers lose, then they cannot make any compensation — hypothetical or real — to the losers that leave both sides better off. If rent control statutes always yield such negative sum games, then they should be rejected uniformly under either standard. The per se invalidation of rent control under the takings clause is thus consistent with any efficient theory of social regulation.

In order to show how this is the case, I propose to organize the discussion around the systematic distortions created in both the short and long run by the systematic gap between market and regulated rentals. In the short term, the analysis focuses on (A) tenant decisions on whether to renew or vacate, and (B) the litigation between landlord and tenant over violations of various “for cause” provisions in the lease. In the long run, it focuses on the (C) incentives for new construction, and (D) the spillover of market transactions into politics.

A. Tenant Decisions to Vacate or Remain

Let us begin with the static analysis, which assumes that

⁵¹ The Pareto standard often highly restricts what can be done. The Kaldor-Hicks standard often leaves it unclear whether the hypothetical compensation required would be forthcoming. Neither standard provides any guidance on how the gains from productive activities should be split between the two parties.
the supply of housing within a given community is fixed, so that the only question is its allocation. For sake of argument I shall assume that the market is competitive in form, a good approximation of all rental markets.\(^2\) Competitive markets have the virtue of always forcing each resource user to measure his demand for the resource against the strongest best rival claim, so that at renewal the tenant in possession has to decide whether the rental demanded is worth it to him in terms of benefits foregone. As the overall demand becomes greater, rents will increase, and some tenants will decide to vacate, while those who remain will enjoy a diminished gain from the transaction (their "consumer surplus") equal to the difference between their reservation price and the new increased rental price. The nonrenewal of leases should not be regarded as a bad social event because someone else with a greater willingness to pay now enjoys the unit.

It is always possible, of course, that some present tenants will have a high subjective utility for a given place, which they cannot back with dollars. In principle the higher payments do not guarantee higher subjective attachment to the premises, assuming that these interpersonal comparisons are viable in this setting. Nonetheless, there is no effective way to know which particular tenant falls into this elusive class, and there is a very substantial reason to fear that the correlation between high utility and great willingness to pay will be strongly positive: some tenants have high income and low benefits from the use for the premises; new rivals may have both high income and high subjective utility. The advantage of the wealth test is that it offers a very good proxy for subjective utility, which is not subject to strategic misrepresentation common with subjective demands not backed with dollars.\(^3\) The market test works to match persons with premises, with a minimum of fuss, bother, and political intrigue.

The introduction of the rent control statute of necessity

---

\(^2\) As of 1980, 58.2 percent of all rental units in the United States were located in structures with four units or less. The proposition is approximately 10 percent lower in central cities. See Baar, supra note 2, at 732 n.27. It is highly doubtful that huge numbers of these small buildings are owned by single large operators. There is also little reason to think that the percentages have changed markedly in the last eight years.

\(^3\) See generally Johnsen, Wealth Is Value, 15 J. LEGAL STUD. 263 (1986) (discussing the role of social wealth maximization in legal analysis).
changes the decision function for the tenant in ways that frustrate the social welfare. No longer will the tenant compare the subjective use of the property to its market value, which represents a minimum estimate of the subjective use of some rival tenant. Instead the tenant will compare the subjective value of leasehold renewal with the lower regulated rent. Whenever the subjective valuation is greater than the regulated price, but lower than the market one, there is an allocative blunder, as the private decision to remain ignores the greater cost inflicted upon some potential rival. The larger the gap between the market and the regulated price, the greater the divergence between private and social cost.

Nonetheless, turnover will occur whenever the subjective value to the tenant falls below the regulated rental. The question is who gets the vacant unit given that demand under regulation is far in excess of supply. Since rents cannot move freely upward, nonprice systems of allocation will be used. Where the landlord controls the process, there will be a tendency to select those tenants with very low risk. Hence the system favors friends and connections, the way in which I got my Columbia College apartment in 1963. If this approach is blocked, then a queue will form for the now available units, and prospective tenants will vie for a place at the front, which can be obtained by making side payments to the right person. Hence the common practice of paying key money to vacating tenants, or of greasing the palm of the superintendent, again as happened with me in New York in 1963. Rent control thus introduces distortions on the ending of old leases and forming of new ones. Applied in countless cases in large cities, it leads to stagnation and social dislocation.

B. For Cause Provisions

The gap between market and regulated rents also imposes pressure on ongoing lease arrangements. It is a commonplace observation that regulation cannot be effective if it applies only to a single dimension of a relationship, such as price. Who would renew a short-term lease on losing terms? Hence rent control statutes spawn elaborate provisions that specify when renewal may be forced by the tenant. If reletting units as rental property is still covered by the rent control laws, then the landlord will try to remove the unit from the rental market. The landlord can
occupy the unit, convert it into nonresidential property or into rental units not covered by the statute, or sell it as a condominium. The farsighted regulator (that is, any regulator burned once) will, therefore, take steps to prevent these depletions of the rental stock, with the blessing of the court.  

It is insufficient, of course, to close the escape hatch on renewal while eviction is left unregulated. Some battles will migrate to the "for cause" language of the statutes, just as they do in the employment cases of wrongful dismissal. For cause eviction within the context of a lease is nothing new, and the grounds specified in the rent control statutes (nuisance, waste, nonpayment) are essentially those found in the ordinary residential leases, especially those of long duration. But there is a critical difference between the impact of the for cause provisions of the lease and the rent control statutes: far greater pressure is placed upon the for cause provisions in the regulated than in the market context.

In the ordinary unregulated market, the landlord has little incentive to manipulate for cause requirements in order to remove a well-behaved tenant. Even a tenant who has committed small infractions is probably safe, as removing this tenant costs the landlord a certain amount of labor, money, and heartache. If the rental market is stable, the landlord can obtain at best only a small increase from reletting the premises. Even when the market has moved, it is often cheaper for the landlord to obtain

---

54 See, e.g., Flynn v. City of Cambridge, 383 Mass. 152, 418 N.E.2d 335 (1981), in which the power to prevent the removal of units from the market was upheld as a proper incident of the city's power, received by delegation from the state, to regulate rentals:

The power to control rents and evictions is not so illusory that it does not comprehend the right and responsibility of preventing removals from its reach.

We conclude that the power to control removals from the rental housing market is essential to the operation of c. 36 [the Cambridge ordinance] and is therefore conferred by implication in the rent control statute.

Id. at 159, 418 N.E.2d at 339.

55 See Baar, supra note 2, at 833-34. Baar lists nine specific grounds of for cause removal: nonpayment of rent, failure to cure, creation of nuisance, illegal use, refusal to afford landlord access to premises for the purpose of repairs or showing the unit to a potential purchaser or mortgagee, refusal to execute required lease extensions, unauthorized subletting, use by landlord's family, permanent removal from housing market, or any other good cause "not in conflict with the purposes of the rent control act." Id.

the rent increase at renewal and not to angle for an earlier and unwarranted dismissal for cause.

However, the rent control laws radically increase the landlord's returns from for cause dismissal. As noted earlier, the net value to a tenant who lives in a rent controlled apartment often equals in present value terms a very large share of the total fair market value of the unit. Removal for cause typically allows the landlord to recapture a substantial portion of the unit's value, for example, by removing the unit from controls by "rehabbing" it, or by selling it as a condominium. Now the battle over for cause dismissal is a high stakes affair. Small deviations from the leasehold provisions therefore are no longer small items for the parties to resolve by informal adjustments. The landlord has strong incentives to exploit minor breaches in order to escape rent control laws.

This change in incentive structure also often leads the parties to adopt weird forensic positions. A landlord may let the premises fall into disrepair, only for the tenant to make the improvements himself (Having the landlord make improvements creates for the tenant the risk of a rent increase that may continue even after the costs of the improvement have been paid for, at least under the old New York scheme.). In the ordinary market context, a tenant on a short-term lease is reluctant to make improvements without some assurance of renewal from the landlord. The landlord is usually willing to allow the tenant to make such improvements unless there is some actual impairment of the underlying premises, for the landlord gains the residual value of the improvements at the expiration of the lease.

The incentives under rent control are radically different. The landlord is no longer concerned with losing the value of the improvement after the expiration of the lease: indefinite renewal by legal command solves that problem. Instead, the landlord may well attack the improvement as a form of "waste," which justifies evicting the tenant under the for cause standard. For example, in *Rumiche Corp. v. Eisenreich* the landlord of a rent-controlled unit allowed the apartment to fall into disrepair, inducing the tenant to make several alterations of the structure

---

that repaired falling ceilings and added certain amenities to the unit. The landlord sued for "equitable" waste on the ground that the substantial alteration of the structure did not meet the standards of the fire code, and were otherwise improper, substantial, and permanent changes in the leased premises. The New York Court of Appeals rejected this challenge on the ground that the statute, not the lease, determined the grounds for dismissal, and that the changes did nothing to alter the essential nature of the unit as a studio apartment.\footnote{Id. at 180, 352 N.E.2d at 129, 386 N.Y.S.2d at 212.} Given the framework of the statute, the decision seems correct. But my point is that litigation of this sort only arises because of the gap between market and regulated price, rather than any concern with the condition of the rented unit.\footnote{This problem can and does arise in the private law, as with the perfect tender suits in nineteenth century sales cases. Often a buyer might reject fungible goods for some trivial defect, not because the defect influenced the value of the goods, but because the market had fallen in the interim. See, e.g., Filley v. Pope, 115 U.S. 213 (1885); Norrington v. Wright, 115 U.S. 188 (1885). Note that in some cases the game playing by buyers is something that the parties will want to avoid. This can be done by varying the terms of the standard contract when appropriate, an option foreclosed by the rent control statutes.} The lesson will not be lost on other tenants.

In many instances, however, the problem with waste may take on more ominous proportions. From the landlord side, the reduction in rent may well yield a reduction in the level of services that can be provided, including matters of maintenance and security.\footnote{Rent Control, supra note 1, makes this point by interspersing pictures of rent controlled properties and bombed out properties and challenges the reader to guess whether he is looking at "Bomb Damages or Rent Control." The answers are at page 320. Good luck.} There is also a substantial peril from the tenant side. The tenant may have some incentive to keep his own unit up, but there is no powerful incentive to maintain common areas. Tenants know that eviction procedures are slow, cumbersome, and costly to the landlord. Tenants also know that only a serious violation of the rules will prompt a landlord to sue. Even if most tenants are virtuous, the common areas can be destroyed by those who are not. One market function of landlords is to police harmful interactions among tenants. That role is compromised by the elaborate for cause protections under rent control.
C. Long-Term Investment

The gap between market and regulated rents also has an effect upon both the long-term operation of the rental housing supply, and upon the operation of the political process. A rent control statute is in part a form of price control, and like all price controls, it results in a systematic gap between the large quantity of goods demanded (because the price is low) and the small quantity of goods supplied (for the same reason). Without regulation, the price would rise, the demand would ease, and the supply would increase until the market was back in equilibrium, as happened in San Francisco after the earthquake. But with the obvious form of redress effectively controlled, some other forms of conduct are necessary to narrow the gap between supply and demand. Two common methods are the queue and the side payment mentioned earlier. By the former, the price to the individual buyer is increased by having to wait to get the goods in question. If the wait is long enough, the price paid by the purchaser (the sum of the transfer payment plus the wait) will just clear the market. However, the wait will do nothing to increase the supply of the goods because the price paid does not go to the seller, and therefore does not induce anyone to bring new rental units on to the market. Even if new construction is exempt from the statute, existing rent control laws give a loud and clear signal that old policies may be reversed so that future units may be subject to similar restrictions. That prospect is, moreover, far from negligible because once those units are occupied, their residents add a new class of voters to the rolls whose interests can no longer be ignored in the political calculus. All rent control statutes thus depress the future total return of any investment. Reduced returns mean reduced investments, so that rent control statutes only exacerbate the housing shortages they are said to alleviate.

---

61 See Baar, supra note 2, at 759 (discussing exemptions for new construction which are common in rent control laws and intended to encourage such activity).

62 In Marcus Brown Holding Co. v. Feldman, 256 U.S. 170, 199 (1921), Justice Holmes noted that “as to new buildings, that the unknown cost of completing them and the need to encourage such structures sufficiently explain” why these are excluded from the operation of the statute. Note that both Block and Marcus Brown dealt with rent control statutes that applied to units already in existence.
D. The Political Dimension

As hinted above, the rent control statutes also have very powerful and unfortunate political overtones. The gap between regulated and market rentals is not fixed by an act of nature. It must be determined in political markets. But the operation of these markets differs in a notable way from that of ordinary rental markets. In the usual private market, both landlord and tenant have made specific investments in an ongoing relationship that is subject to the risk of strategic behavior at renewal. The tenant must incur the costs of finding new premises if the landlord raises the rental above market, while the landlord faces the costs of finding a new tenant if the present tenant will not agree to any increase. Yet in the private market, both landlord and tenant are reluctant to exploit the vulnerability of the other side for fear of retaliation. A quick and easy agreement on renewal spares both sides the risk and cost of protracted conflict, and is the norm in most housing markets, where present tenants usually face increases similar to those required of newly arriving tenants. The bilateral holdout problem is effectively controlled by increasing the number of alternative opportunities available. “Thick” markets work more smoothly than “thin” ones.

The situation is far more complex with rent control because some collective decision is necessary to decide the permissible level of rent increases. Instead of having competitive markets make the decision, the law must necessarily introduce political formulas whereby the majority of voters within the jurisdiction, subject only to loose constitutional rate of return constraints, determine the formula for allowable increases. The political battles are often ugly, acrimonious, and uncivilized. The costs are extensive, given the very wide bargaining range between the market and the minimum allowable regulated rents. Factional struggle can dissipate the gains that are otherwise generated by voluntary exchange. The 1942 New York law, like other older statutes, was so rigid and oppressive that it decimated the housing stock of New York for a generation by forcing the abandonment of many units. More modern stabilization statutes con-

---

63 See generally TOWARD A THEORY OF THE RENT-SEEKING SOCIETY (J. Buchanan, R. Tollison & G. Tullock eds. 1980). For its application to constitutional matters, see Epstein, supra note 4, at 713-14.
stantly speak of "fair rates" of return on the model of public utility regulation. But even here there is always the danger that the regulations will overshoot their mark, so that some landlords will find it profitable to first milk and then abandon their units, which become a source of urban plight and public mismanagement. While the law may require some reasonable rate of return, there is many a slip between cup and lip. The restrictions on rents, coupled with increases in taxes, may force many landlords into bankruptcy.

The question then arises, why use the rate of return system of regulation at all? Consider the reason why utility rate regulation is adopted. The services supplied are characterized by increasing returns to scale, which means typically that a single supplier can provide the goods more cheaply than two or more competitive firms, which must incur heavy duplicative fixed costs. Regulation may therefore be justified as a way to insure that the single producer does not extract the monopoly profit from the consumers so served. Similarly, some constitutional restraints are necessary to insure that investors in the regulated industry do not have their capital confiscated by state regulation. This system of regulation is both costly and uncertain but one can envision the allocative gains that it is supposed to generate.

But the differences between utility regulation and rent control are critical. Rent control does not displace an unchecked

---

64 See Daley & Meislin, New York City, the Landlord: A Decade of Housing Decay, N.Y. Times, Feb. 8, 1988, at A1, col. 1. The news article recounts in painful detail the difficulties that New York City has in running housing units that it acquired in tax foreclosure or after abandonment. Nonetheless, the article has no sense of the structural reasons for the vast increase in housing failures. Thus, it states, "At the start, the city was slow to seize buildings from unscrupulous or inept landlords and when it finally did the properties were rundown." Id. at col. 2. There is no hint of the role of regulatory restrictions and tax policy in the rate of housing failures.

natural monopoly. Instead, it is used as a substitute for what could be a highly, though surely not perfectly, competitive market. The market failure arguments do not work for rental housing. What is missing in the case for rent control is the identification of the social gains that justify the huge costs of regulation. The political effort to set the gap between market and regulation only increases the level of social losses. There is no social case for rent control in either the long or the short run.

IV. THE COMMUNITARIAN COUNTERATTACK

I have thus far urged that rent control statutes are per se unconstitutional, and that this conclusion makes good sense even if we expand our vision beyond constitutional text to take into account its anticipated social effects. Rightly understood, the just compensation clause of the Constitution directs us to a theory of efficient regulation. The arguments are, I think, so conclusive that it is difficult to think of any neutral normative argument that could justify the use and spread of this system. The economics profession is united over rent control, as it is not over any other issue. The strength of the case is shown by the efforts to circumvent it. There is simply no effort to show that misallocations associated with rent control do not exist. Instead, the justifications for rent control statutes take a very different turn. While I cannot evaluate all of them here, it is instructive to look briefly at one recent legal-philosophical effort provided by Professor Radin.66

Professor Radin adopts the strategy of confession and avoidance by explicitly rejecting all standard accounts of efficiency, and invoking in their stead the "intuitive general rule" that the interests of the landlord or of some potential tenant do not reach the same level of dignity or strength as that of the present tenant in possession. In a sense the argument dates back to Justice Holmes in Block v. Hirsh, in which he observed, "The preference given to the tenant in possession is an almost necessary incident of the policy, and is traditional in English law."67

---

67 256 U.S. 135, 157 (1920). There are no citations, and the point is overstated if not wrong because it ignores all the incidents, such as wardship and marriage, that attach to the tenant in possession, not to mention the excessive grounds for forfeiture. For an account of the feudal system, see A. SIMPSON, A HISTORY OF THE LAND LAW (2d ed. 1986).
In Radin’s hand the argument appears clothed in somewhat different garb. A few quotations capture Radin’s general gist: “The intuitive general rule is that preservation of one's home is a stronger claim than preservation of one’s business, or that non-commercial personal use of an apartment as a home is morally entitled to more weight than purely commercial landlord ing.”

Again: “The intuitive general rule I just mentioned does not apply to would-be tenants. When we consider people who are tenants elsewhere and wish to become tenants in the rent-controlled community, we are not struck with a similar general intuition of a strong claim.

I confess that my intuitions are not so well developed as Professor Radin’s. If we do not stick with either Pareto or Kaldor-Hicks, then the old utilitarian maxim that “every person should count for one and only one” is a far better way to do business. It is very risky to announce that some persons or some roles count for more than others. Potential entrants to certain markets are real people whose goals, aspirations, and desires matter as much as those of present tenants. Opportunity costs not only include unrealized gains that are unexperienced by losers, but also their frustrations and disappointments in the toilsome effort to find housing when supplies are tight and rents are high. Once we intuit that certain positions, and hence certain people, are special, then we have to determine just how special they really are. In practice any overall inefficiency or inequity can be justified by saying that the interests of a tenant in possession (who has not protected himself by contract) is two, five, or ten times that of some would-be person who wants to raise a family in a decent environment, or to move back home after college to live near the family. It is often very difficult to know whether neighborhood stability is a source of strength or stagnation, and whether mobility is a sign of vitality or decay. The raw turnover rates are not enough. Much depends upon how the decisions to stay or go are made, and on this point rent control systematically generates all the wrong incentives.

Professor Radin’s principle cuts against the very idea of an open society in which there is equal opportunity for advancement and trade for all. The same principle could be used to jus-

---

*68 Radin, supra note 66, at 360.
*69 Id. at 361.
tify exclusionary zoning, including that which is based upon ra-
cial or ethnic grounds. Legal racial segregation had its
beneficiaries, which is why it survived. Radin’s principle could
be used to justify the perpetuation of guild monopolies, on the
ground that workers in an established trade are entitled to pro-
tection that new rivals with advanced techniques are not allowed
to enjoy. It could be used to justify elaborate systems of price
supports for farmers, on the ground that established farmers
should not be subject to the heartaches of the market in their
quest to maintain a constant standard of living. And it can, of
course, be used to erect powerful barriers against immigration of
cheap foreign labor (my grandparents, for example) on the
ground that we attach some greater utility to established resi-
dents of the United States than we do to mere potential citizens
who wish to cross its borders. Economic accounts of efficiency
have been attacked countless times because they leave out of the
social equation fundamental concerns with justice and fairness
that are thought to be an inseparable part of our social life. How
ironic that those tests are the only ones that direct our attention
toward the overall effects of the purported regulation — includ-
ing the losses to landlords and potential tenants, as well as to
society at large — that the “communitarian” approaches ignore.
The social welfare standards of economists give no particular
favor to one class of individuals or occupations, but instead
point powerfully to the acceptance of the principle of freedom of
contract in markets that can approximate the competitive ideal.

My “intuitions” favor an open society in which persons
must purchase what they want from the owner of resources, and
not plan and scheme to get the state to operate on their behalf.
The cant about communitarian ideals offers a convenient cloak
to allow the “haves” to exclude those unlucky enough not to
have gotten there first. The constant iteration, also made by Ra-

70 The point rings true for Radin, who notes that one purpose of the rent control
laws is “to make it possible for existing tenants to stay where they are, with roughly the
same proportion of their income going to rent as they have become used to.” Id. at 352-53.
This is similar to the idea that farmers should continue to enjoy the level of prosper-
ity they had in the best of times through a system of tax-supported minimum prices.

As an aside, Radin’s general proposition about rent control describes only the rare
rent control or stabilization statutes, like San Jose’s. Regulated prices are determined
uniformly without regard to tenant income. Indeed, one of the distributional shames of
the system is that it tends to provide large subsidies to older tenants with substantial
incomes.
that residential housing is not just another market good has been heard before. Labor unions have often said that labor is not an article of commerce, but they do not withdraw themselves from sale; they charge a monopoly price. Medical and legal services have been sharply restricted on the grounds that no "noble profession" should have to face the competition of low-cost producers. Oil and gas are special commodities that should be protected against cheaper imports because they are necessary to protect the national security of the United States. The claim for special communities is simply a disguised appeal for special monopoly privileges that should be rejected across the board, regardless of the guise under which it appears. There is simply no standard of social welfare that justifies the operation of the rent control statutes in any form.

The real questions of policy that should be debated are those concerning the legal transition rules that should govern the move toward deregulation. As always, it is far more difficult to return to unregulated markets than it is to maintain them in the first place, given the reliance interests that grow under the new regime, and the powerful political forces that work to keep them in place. The easiest solution is one whereby courts would do two things: first, ban any new rent control stabilization ordinance; and second, order the inexorable relaxation of current restrictions by raising existing caps by, say, 10 percent a year, every year, until the restrictions hover harmlessly far above market prices.

The questions over rent control go to the heart of what private property and free markets are about. It should not be surprising to find that there is a powerful congruence between what the Constitution requires as a matter of textual interpretation, and what the theory of efficient regulation requires as a matter of sound social policy. It is therefore something of an anticipated tragedy that we continue to move heavily in the direction of more and more government regulation of the housing markets. Our achievement is in a sense unique, for we have managed to

---

forge legal arrangements for rental housing that simultaneously offend both explicit constitutional norms and sound economic theory.