

A Review of Changes in Income and Expenses, 1967-91

Introduction

The changing relationship between rents, operating and maintenance expenses, and owner income lies at the very heart of rent regulation. Other things being equal,¹ rents which generally preserve the inflation adjusted value of net operating returns over time accomplish one of the central goals of the stabilization system: fairness to good faith investors. In New York City measuring the effects of stabilization on net operating incomes is a matter of exceptional complexity. Massive shifts in the regulated stock over twenty four years make point to point comparisons of income and expense profiles impossible to develop with any precision. Since 1969 over 700,000 units have moved from rent control to stabilization. Some 60,000 stabilized units in post-war buildings have moved from rentals to co-ops. About 90,000 stabilized units are now in converted buildings and will be decontrolled upon vacancy. In addition, thousands of units left regulation via abandonment or foreclosure by the City. Only about one in five currently stabilized units were subject to stabilization in 1969.

The difficulty of making such measurements is, nevertheless, clearly outweighed by the

¹ "Other things" of relevance here might include population trends, tenant incomes, the average age of the regulated housing stock and the return on investments of comparable risk and liquidity. To preserve the value of net operating incomes in the face of a declining population, sagging incomes, aging properties and declining returns on comparable investments would be to implement a form of profit insurance never intended by the system. On the other hand, modest gains in average net operating income might be expected in the face of a rising population, higher incomes, a decline in the average age of regulated buildings (reflecting new construction) and rising returns on comparable investments. Of course, "other things" are rarely equal - except perhaps on economics exams.

need to develop some working understanding of the impact of stabilization on relative industry returns. The last report on this issue was issued by the RGB staff in 1989. Since that time a variety of new data sources have been made available to the Board. In 1990, for the first time, the staff was provided with information on rents and operating expenses from income and expense ("I&E") statements on file with the Department of Finance. In 1992, to test whether the I&E statements were generally reliable, forty-six properties were carefully audited. In addition, aggregate data on changing market values of multi-family buildings from 1975 through 1992 has been provided. Data on tax arrearages has been made available from the Department of City Planning. Finally, the State Division of Housing and Community Renewal has contributed data on registered rents. These considerable efforts have allowed us to examine long term trends with an eye towards changes in net operating incomes. In light of these information advances we have prepared an update of the 1989 report. While a few questions will require more time before conclusions may safely be drawn, many of the questions which troubled the Board over the past decade have been answered.

History of the Income and Expense Issue

Nineteen ninety-three marks the fiftieth year that New York City has been subject to some form of rent regulation. The long term impact of rent regulation on the quality and availability of housing is, therefore, an issue which has been a subject of public concern for some time. In his

well known study, *The Urban Housing Dilemma: The Dynamics of New York City's Rent Controlled Housing*, George Sternlieb asked property owners in 1967 many of the questions that continue to occupy center stage in the debates over rent regulation. The focus of these questions is summarized in his introduction:

"The rent control formula, as presently implemented in the city, has provision for a number of ways of securing rent increases, both in return for additional investment and in order to prevent undue owner hardship; but the formula raises numerous questions. How well have these increase methods kept pace with increased costs? To what degree has maintenance suffered as a function of rent control? What elements of the Rent Control Law are being utilized and are there variations in the knowledge and utilization of these formulas? Are there significant variations between operational patterns of rent controlled and non-rent controlled structures of which the city should be aware? What is the influence of tenant ethnic origins and welfare reciprocity upon landlord attitudes? For that matter, who are the landlords and what are the factors which enter into their decision making, particularly in relationship to maintenance and other forms of investment procedure?

New York City's housing policies and rent control must be considered as one element in the broad matrix whose function is to provide, both now and in the future, a satisfactory environment for the city's inhabitants. Currently, most social concern is with the tenant's needs. In the long run there is the question of whether these can be satisfied without a reasonable degree of assured return to the landlord.

The mere age of the city's housing stock requires continual reinvestment. Within the context of our time, most of the funds must be secured from the private market. How

competitive, given the variety of outlets for private capital, is New York City's housing?"

In short, Sternlieb's inquiry concerned the broad social and economic environment affecting investment in rental housing. An isolated examination of the relationship between rental income and operating costs without a careful look at how these other matters might affect (dis)investment patterns provides an incomplete basis for policy analysis. Yet, a full update on the wide variety of matters covered in his study would be very costly and time consuming (Sternlieb's field work began in 1967; his report was issued in 1972). For our immediate purposes, we will only examine Sternlieb's findings on the relationship between rents and operating costs in pre-war buildings.

The Pre-War Stock in 1967

Since "expenses" and "repair and maintenance costs" were separated in Sternlieb's analysis, and since these are combined in more recent data, we have combined them here for the purpose of later comparisons.

Mean operating cost to rent ratios² are reported in exhibits 3-1 and 3-5 in Sternlieb's report. Again, Sternlieb did not combine "expenses" and "repairs" as a percent of net rent received [see text accompanying exhibit 3-1]. The samples for expenses and repairs as a percent of rent received appear to be virtually identical - with only 6 of 664 buildings missing in the repairs table because of the "lack of baseline data." Consequently, combining the two tables to get expenses and repairs as a percent of net rent received is not too risky. Doing so provides the

² The O&M to rent ratio is the proportion of all rent that landlords spend on operating and maintenance expenses. A declining O&M ratio over time generally indicates that landlords are in a better position while a growing O&M ratio indicates that operating expenses are taking a larger portion of landlords' revenues, thereby leaving less net operating income.

O&M Ratios in Pre-war Structures in 1967

	<u>Expenses</u>	<u>Repairs</u>	<u>Total</u>
<u>Old Law Structures</u>			
5-19 units	66.05%.....	16.9%.....	82.95%
20 units or more	57.47%.....	12.6%.....	70.07%
<u>New Law Structures</u>			
5-19 units	60.15%.....	16.2%.....	76.35%
20-49 units	56.03%.....	13.0%.....	69.03%
50 units or more	52.54%.....	10.9%.....	63.44%
<u>Structures Built After 1929</u>			
10-49 units	54.04%.....	9.3%.....	63.34%
50 units or more	52.24%.....	8.9%.....	61.14%
<u>Small Structures</u>			
3 and 4 units	67.31%.....	19.5%.....	86.81%

mean O&M to rent ratios for the pre-war universe in 1967 as shown in the table above.

Note that “net rent received is a residual of gross potential residential rents, including imputed rents for superintendent and other resident employees and/or owners, and commercial rents; less vacancies and bad debts and other gross income elements” (p. 22, emphasis added). This observation is critical in making comparisons with more recent data on O&M to rent ratios which will be examined further on. Note also the affect of age and size upon the O&M ratios.

The universe of buildings examined by Sternlieb in 1967 included some 881,312 units in rent controlled (pre-war) buildings (Exhibit AII-8).³ Tens of thousands of these properties were, no doubt, lost to abandonment since that time. Today some 707,000 pre-war apartments fall under rent stabilization while about 120,000 remain under rent control. Rent controlled properties with fewer than six units do not, as a matter of law, fall under rent stabilization upon vacancy. Since smaller

³ The largest category was the New Law structures with 20-49 units which included 296,460 units.

properties have undergone vacancy decontrol and many marginal properties have been abandoned, one would expect that only a fraction of the buildings with very high O&M to rent ratios would have fallen under stabilization. Consequently, the average O&M ratios for buildings examined by Sternlieb may be affected somewhat if all properties which did not eventually fall under stabilization were removed from the sample. Those that made it into stabilization probably had slightly lower than average

O&M ratios in 1967.

Examining the proportion of units in each class and the relative mean O&M ratios, and eliminating the 3-4 unit category, it appears that pre-war properties combined had a mean O&M to rent ratio of about .70.⁴ Assuming a loss of the most distressed of these properties to abandonment and a slight loss (of five unit buildings) to decontrol, it appears that the properties which eventually fell under rent stabilization had O&M ratios in the mid to high 60s. Keep in mind that this estimate includes commercial income in the denominator of “net rent received”. While not a precise estimate, this is the only figure available with which to compare with the current O&M ratios of pre-war buildings. As will be shown further on, it appears that O&M ratios in the pre-war stabilized stock were not demonstrably different in 1967 from the O&M ratios found in our recent study of 1991 income and expenses.

⁴ This figure is derived by multiplying the mean O&M ratios listed above by the number of units in each respective class (See Sternlieb, Exhibit AII-8), summing and then dividing by the total number of units in all classes (excluding 3-4 unit properties as noted).

The failure to achieve lower O&M ratios may have been affected, in part, by non-regulatory influences: aging buildings, relative declines in tenant income, vacancy losses etc. It is important to recall that owners of rent controlled units have been entitled to market rents upon vacancy except when newly stabilized tenants have initiated and prevailed in Fair Market Rent Appeals. Such appeals occur only in a fraction of eligible cases. Also, once stabilized, rents in pre-war buildings are increased periodically in accordance with established rent guidelines. Finally, rents may increase as a result of major capital or individual apartment improvements.

Perhaps a better measure of changes in O&M to rent ratios is found in the post-war universe to which we will later turn our attention.

Information Development After the Urban Housing Dilemma

Moving beyond 1967 allows us to focus on the workings of the Rent Guidelines Board and the impact of its decisions on the changing relationship between rents and operating costs. In order to put our newest information in perspective it is important to recall the history of Board practices and policies relating to this issue.

In 1969, in response to an extremely tight rental market with a vacancy rate at 1.23%, the newly enacted Rent Stabilization Law limited the rents of some 325,000 previously unregulated post-war units and about 75,000 decontrolled units. Specified increases above levels that had existed on May 31, 1968 were established by the City Council. Thereafter, the Rent Guidelines Board was given responsibility for further annual adjustments.

In the early days of stabilization (1970 to 1974) the RGB focused primarily on changes in operating and maintenance expenses (i.e. the Price Index of Operating Costs) to determine its rent guidelines. Dennis Keating, in his comprehensive

review of the rent stabilization system (*Landlord Self-Regulation: New York City's Rent Regulation System 1969-1985*, Journal of Urban & Contemporary Law, Vol. 31:77) found that

"Beginning in 1970, the RGB relied heavily, but not exclusively, on the BLS operating cost price index for its determination of rent increases. Initially, the absence of tenant representation on the RGB, the use of the operating cost price index, the RGB's secrecy, and its consideration of additional factors to justify rent increases occasioned little controversy. These issues, however, would later become much debated in a public forum. During this early era, the RGB convened annually, held no public hearings, and quietly issued annual rent increase orders."

Following a period of vacancy decontrol, in 1974 the State Legislature passed the Emergency Tenant Protection Act (ETPA). The act extended rent stabilization to hundreds of thousands of units previously subject to rent control. At the same time, the RGB was required to include designated seats for tenant and owner representatives.

Shortly after passage of the ETPA, in a letter of August 6, 1974 to Roger Starr (Administrator of the Housing Development Administration), Emmanuel Tobier (Chairperson of the Rent Guidelines Board) seems to have foreseen the probability that the RGB would need better information to reconcile the conflicting demands of tenants and landlords.

". . . we must re-examine the current relationship between operating and maintenance costs and building income in the rent stabilized sector . . . building owners might be willing to provide this data. Perhaps the easiest route might be to look at the relationship between operating costs and revenue, by examining a representative sample of buildings, and

incorporate this information into our guidelines."

By looking to voluntary disclosure of income and expense information from owners, Professor Tobier may have been attempting to catch a brief moment in time before the landlord-tenant relationship worsened beyond compromise. In fact, the last half of 1974 and the first months of 1975 were an unusually troubled period for the RGB. Lawsuits were filed challenging the legitimacy of the Board's orders. As a result, one rent guideline was invalidated on the procedural ground that the Board had failed to adequately explain the factual basis for its order and its methodology. This court decision led to the development of detailed explanatory statements which now accompany each new set of rent guidelines.

Dennis Keating sums up the atmosphere of the mid-70's -

"The protracted and acrimonious public conflict, in which the RGB's credibility, conclusions, and procedures were politically and legally challenged was a turning point in the history of the rent stabilization system. No longer would the rent-adjustment process under self-regulation be shielded from public scrutiny . . . Henceforth, the RSA and tenant groups would become increasingly combative . . ."

Although the RGB was sued by both landlord and tenant groups in the late 70's, the courts refused to invalidate the Board's methodology. The RGB continued to rely to a great extent on the Bureau of Labor Statistics' Price Index of Operating Costs (PIOC).

In addition to the studies produced by the RGB, tenant and landlord groups attempted to examine the income and expense issue from their different perspectives. Landlords argued that the net operating income of rent stabilized buildings was declining due to large increases in operating costs and insufficient rent increases. Tenants, on

the other hand, believed that rents were rising faster than tenant incomes. During this period of stagnant income growth and high inflation in New York City it is possible that both groups were correct in their assertions.

It was not until 1982 that the issue of profitability of rent stabilized housing was raised once again by the RGB. In that year Urban Systems Research and Engineering (USR&E) replaced the Bureau of Labor Statistics as the contractor for the PIOC. In addition to the price index, the RGB also commissioned USR&E to undertake research on six so-called "special topics" including:

1. Operating cost to rent ratios
2. Mortgage financing and refinancing characteristics
3. Rates of return
4. Tenant turnover patterns and the distribution of lease terms
5. Tenant income characteristics
6. Use of city tax abatement programs and the use of energy conservation programs

In a publication of June 1, 1982 entitled "Research Design on Special Topics" USR&E broadly outlined a "rate of return" (i.e. landlord profit) study. The authors examined several different definitions of "rate of return" and the sources of data which would be required to examine actual landlord profits. They concluded that:

". . . it will be impossible to secure all the information necessary to calculate the actual rates of return on any significant or usable set of buildings. Such a data base would include owners' annual tax returns, annual financial statements on the buildings, financing arrangements and purchase/sale prices. This is evidently impossible to acquire."

It is unclear why the consultants concluded at that time that sources of data for a study of actual landlord profits were "evidently

impossible to acquire." USR&E did propose an alternative study of rates of return, using "a set of prototypical buildings, intended to be representative of the stabilized inventory." However, this study was never undertaken.

In 1982 USR&E was also commissioned to produce a landlord expenditure study. A sample was selected to be representative of all stabilized buildings in the city. In the fall of 1982 a survey questionnaire was mailed to over 2400 owners of stabilized buildings. In essence, the questionnaire asked owners to provide a detailed breakdown of operating and maintenance expenses for 1982. Approximately 400 landlords returned fully completed questionnaires.

The primary purpose of the 1982 Expenditure Study was to update the expenditure weights in the Price Index of Operating Costs. An expenditure weight is the percentage of landlord operating and maintenance (O&M) cost attributable to a given type of O&M expenditure (e.g. in 1982 the Price Index of Operating Costs assumed that fuel costs were 37% of all landlord expenditures in pre-'47 buildings. However, the 1982 Expenditure Survey found that owners of pre-'47 buildings spent only 29% of O&M on fuel in 1982. As a result, the expenditure weight for fuel was revised from .37 to .29 the following year). Precise expenditure weights are needed if year-to-year changes in overall O&M costs are to be accurately measured.

For reasons that remain unclear, Table 14 of the RGB's annual explanatory statement, which details the history of changes in the O&M to rent ratio, was NOT updated following completion of the 1982 Expenditure Study, even though the information to do so was available. Although tentative plans for a "operating cost to rent ratio" study were made in 1984, plans for the study were discontinued in 1985.

In the mid-80's criticism of the Price Index of Operating Costs continued to build. For instance, in 1985 the New York State Tenant and

Neighborhood Coalition issued the following statement:

"The Price Index is not only conceptually flawed, but yields no information whatever about actual landlord incomes, expenditures, or profits - the true measures of the economic condition of the industry. In contrast to the practices of every other body charged with the responsibility of regulating prices in the public interest, the Rent Guidelines Board neglects all questions of income and profitability when considering the need for rent adjustments."

At least some of these sentiments were apparently shared by the Board of Estimate, which, in a unanimous vote in 1985, passed a resolution supporting an examination of owners' books and records. The city administration did support legislative initiatives to allow such an examination. However, none of the proposals to require owners to "open the books" ever passed the State Senate. In the fall of 1985 members of the RGB asked the staff

". . . to prepare a report, in consultation with New York City's Department of Housing, Preservation and Development (HPD) and the New York State Division of Housing and Community Renewal (DHCR), regarding how the Board could obtain a representative sample of owners books and records and how such a sample and examination could be of use to the Board . . ."

After contacting both DHCR and HPD regarding the feasibility of obtaining a sample of owners' books it was concluded that

". . . Since both HPD and DCHR [sic] have stated that such a study could not take place without a legislative change which would either grant DHCR jurisdiction to conduct the study or grant subpoena power to the New York City Rent Guidelines Board, such a study could not

be undertaken . . ." (Research Report Regarding the Feasibility of Auditing a Representative Sample of Owners Books and Records dated January 31, 1986)

The situation that the RGB found itself in in 1986 was best summarized by an article in the New York Times entitled "Dissatisfaction with Stabilization's Cost Index Grows, but No Consensus has Emerged on Alternate System" (*New York Times*, July 6, 1986). The article found that the two RGB tenant representatives had resigned "citing personal reasons but also dissatisfaction with this year's increases and the way they were determined."

In 1987, reflecting a continued dissatisfaction with the price index methodology, the Board of Estimate rejected the price index contract. The consultant selected for the study (USR&E) performed it gratis at the request of the Commissioner of the Department of Housing, Preservation and Development. Later that year the consultant filed a voluntary petition for bankruptcy protection. In 1988 and 1989 the price index was procured through the City University Research Foundation and, therefore, did not require Board of Estimate approval. Until 1991, the Rent Guidelines Board did not commission or fund the price index - procurement and payment were handled directly by the Department of Housing Preservation and Development (except in 1988 and 1989 as noted).

By 1987 it appeared that the debate over landlord "profits" had reached a standstill. However, in 1986 the City Council enacted Local Law 63, which mandated that owners of income-producing properties file income and expense statements with the City's Department of Finance. The law was passed in order to aid the city in determining assessed values of properties.

Local Law 63 filings were, of course, of much interest to the RGB, since a representative sample of these properties' income and expense

statements could be used to calculate and update operating and maintenance cost to rent ratio. In addition, if the filings were obtained by the RGB on a regular basis they could be used to calculate year-to-year changes in landlord operating and maintenance costs and income to examine the accuracy of the Price Index of Operating Costs. However, Local Law 63 filings by themselves are not sufficient to calculate landlord "profits" since they do not contain any information on mortgage expense, changes in building resale values, and so on. In addition, these filings cannot by themselves replace the price index because the time periods reflected in the filings are at least one year old at the time of aggregation. The Board's mandate calls for more recent cost data which only the price index supplies.

Not long after Local Law 63 was enacted, litigation concerning various aspects of the law made it impossible for the RGB to obtain any of the new information. A temporary restraining order was imposed prohibiting the City's Finance Department from releasing any Local Law 63 data. On March 9, 1988 the RGB requested the city's Corporation Counsel to seek a lifting of the temporary restraining order. Although the attempt to lift the order was unsuccessful, the court order did eventually expire in March of 1989. Unfortunately, the RGB was still unable to obtain any Local Law 63 data. In a letter dated April 22, 1989, Anthony Shorris, Commissioner of the Department of Finance explained that until the case was fully settled the data would be reserved for Department of Finance purposes only. In addition, key entry of the data had not yet been implemented and would take some time.

In April 1989 Harriet Cohen, a tenant member of the RGB, requested that staff review "Table 14" of the Board's annual explanatory statement. "Table 14" contains a calculation of the operating and maintenance cost ratio for rent stabilized buildings from 1972 to the present (see Appendix C, Table C.3). After thoroughly reviewing

the history and methodology of "Table 14" staff concluded that "between 1970 and 1982 the "Table 14" O&M ratio seems to have diverged from the actual cost and rent data which can be obtained by using HVS and operating cost studies." The staff review did not conclusively show that the "Table 14" O&M to rent ratio was mistaken. However, it did show that "a lack of sufficient new survey data over the last 20 years has resulted in a present inability to supply valid corroborating evidence for the statistical and economic assumptions underlying "Table 14"." **The staff review suggested that the problem with "Table 14" most likely was a result of the inaccuracy of the Price Index of Operating Costs in measuring actual landlord expenditures between 1970 and 1982. It was strongly suggested that new studies be undertaken to:**

". . . provide a new O&M to rent ratio in both mean and median terms. Perhaps more importantly, a new study of rents and expenses could analyze the distribution of buildings in terms of varying O&M to rent ratios. This would help inform the Board as to the number of rent stabilized buildings operating at the margin, and the proportion of those with adequate net operating income. Finally . . . the PIOC (Price Index of Operating Costs) probably needs to be updated (to make it) . . . a more reliable indicator of cost increases in rent stabilized housing."

The events of the summer of 1986 were repeated in May of 1989 when the two tenant representatives resigned from the Board. In their letters of resignation Harriet Cohen and Stephen Dobkin stated that the city administration had "conspired to make it impossible . . . to obtain any data on owner profits or the steadily rising value of residential real estate" and that the City University Research Foundation had "once again been misused to produce the Price Index...which reflects

only the owners' concerns." In addition, both called on the RGB to expand research efforts.

In the spring of 1990 the new city administration actively supported the RGB's efforts to obtain summary data from owner local law 63 income & expense filings. RGB and Finance staff worked together to produce the first I&E (income & expense) study. The methodology of the study is contained in *Rent Stabilized Housing in New York City: A Summary of Rent Guidelines Board Research, 1990*. Subsequent Income and Expense studies were produced in 1991, 1992 and 1993.

The Post War Stock in 1970

Before moving to the major findings of these studies we will need to revisit our analysis of the relationship between rents and operating costs in post-war buildings at the beginning of rent stabilization. This analysis was included in RGB's 1990 Research Summary (pages 26-30):

"Using an estimate of the mean rent for stabilized post '46 apartments (\$203) derived from a special tabulation of the 1970 decennial census and comparing it to the mean operating cost in 1969 (\$110) found by the Bureau of Labor Statistics in its 1970 study of stabilized apartment houses yields a mean O&M ratio of .54. However, since the operating cost study measured 1969 costs and the census measured 1970 rents, it is possible that the true O&M ratio for 1970 may have been as high as .58 (adjusting for subsequent price increases). As far as we can tell, the "true" O&M ratio probably ranged between a low of .54 and a high of .58. The O&M ratio for 1970 in "Table 14" [the RGB index of rents and operating costs] was .55 and falls into this range."

An examination of these data sources in 1989 led to a conclusion that the .55 estimated O&M ratio for post-war buildings in 1970 appeared

to be reasonable. This continues to be the best available estimate.

It is important to note, however, that this is an estimate of the ratio between operating costs and residential contract rents. The rents used here do not reflect vacancy or collection losses or commercial income. The 1967 O&M ratio for pre-war properties previously discussed is a ratio of operating costs to net rent received which adjusts for such losses and includes commercial income.

* * *

In short, we have concluded that the best estimates of the relationship between operating costs and rental income in the rent stabilized sector - at the outset of rent stabilization - are as follows:

- **In pre-war buildings which eventually fell under stabilization approximately 65¢ to 70¢ of each rent dollar actually collected was spent on operating costs in 1967.**⁵
- **In post-war buildings which first fell under rent stabilization in 1969, approximately 55¢ of each rent dollar contracted for in residential units was spent on operating costs.**

Today's Income and Expense Issues

The Pre-War Stock Today

Now, turning to the more recent data we find further complexities. The pre-war stock continues to include a significant number of rent controlled units. While contract rents for stabilized units in the pre-war stock were \$512 according to the 1991 HVS, residential rents actually collected were much lower at \$451 according to statements reflecting 1991 incomes and expenses filed with the Department of

⁵ See supra p. 34-36.

Finance. The effect of rent controlled units along with vacancy and collection losses and preferential rents thus becomes quite clear. These factors have a large impact on revenues in pre-war buildings independent of the influences of rent stabilization. The best we can do in terms of a comparative O&M ratio for the pre-war stock is a straightforward comparison of operating expenses with total building income (which appears comparable to Sternlieb's "net rent received"). This results in a ratio of .70. If we adjust the operating expenses downward by 8% (reflecting an estimate of over-reporting of expenses derived from our 1992 audits) the ratio is .64. Consequently, **the relationship of operating expenses with total building income in the pre-war stock in 1991 appears to be in the same range (.64 to .70) as it was in 1967.**

A few more qualifying observations are in order. First, pre-war buildings have aged some 26 years since 1967 and thus could be expected to have experienced rising O&M ratios - in the absence of regulatory changes. Second, collection and vacancy losses are probably quite a bit higher now than in 1967.⁶ The gap between rents registered with DHCR and rent collections rose sharply in 1991 reflecting, in part, the effects of the current recession on collection and vacancy losses. In a related development, there has been a sharp decline in tenant incomes relative to rents. In 1970 the median gross rent as a percent of income was 19% for rent controlled households.⁷ In 1991 the median gross rent to income ratio for stabilized pre-war buildings was over 29%.⁸

⁶ Sternlieb found vacancy losses for most buildings ranging from .4% to 2.4%. Similarly, collection losses for most buildings ranged from a negligible .1% to 2.3% (see Sternlieb exhibits 2-2 and 2-3 and accompanying text). With over 4% of units in pre-war buildings vacant and available for rent in 1991, vacancy losses have clearly risen. We suspect that collection losses have also risen significantly.

⁷ Sternlieb, *Housing and People in New York City*, Exhibit 5-12. Sternlieb's analysis was based upon a special tabulation of the 1970 decennial census.

⁸ 1991 Housing and Vacancy Survey, Series IA- Table 36.

The Post-War Stock Today

Turning now to the post-war stock further complexities appear. One would expect that, as in the pre-war stock, residential rents collected would be below the contract rents reported in the 1991 HVS. This, however, is not the case. The I&E data for 1991 indicates that, on average, \$653 in rent was collected for each apartment in post-war buildings. The HVS data indicates that the average contract rent for these units [excluding stabilized units in co-ops] was actually \$652. While collection and vacancy losses are much smaller in post-war buildings (and rents received are not affected by the presence of rent controlled units) one would expect rent collections to be a bit less than contract rents. The staff's Table 14 rent index (updating a \$203 average rent for 1970) suggests that the rent guidelines alone should have resulted in an average rent of some \$662 - and that would not include administrative increases authorized for major capital improvements and individual apartment improvements. However, at least some of the increases authorized by the RGB and the DHCR are not charged at the high end of the market and this may partly explain why the \$652 is lower than expected. Rents reported to surveyors are rents actually paid - including preferential rents. In short, the \$652 figure for contract rents, while lower than actual rent collections would suggest, is still reasonable enough to be explained by sampling differences between the HVS and the I&E data.

Comparing the \$652 HVS figure to average operating costs of \$470 reported in the I&E data results in a ratio of operating costs to contract rents of .72. Adjusting the \$470 figure by the 8% suggested by our audit findings produces a ratio of .66. Thus, **it appears that ratio of expenses to contract rents for post-war stabilized buildings has risen (from .55 in 1970) to at least .66.**

Again, a few qualifying observations are in order. Although some post-war stabilized units were newly constructed after 1970 (fewer than 10%), the average age of post-war buildings has obviously risen over 23 years. This alone would have resulted in some rise in O&M ratios. Second, less than two out of three of the original stabilized post-war units remain in unconverted buildings. Our operating cost and rent figures reflect only the approximately 200,000 units remaining in unconverted post-war properties. If conversions typically occurred in better and newer buildings this would leave behind properties with higher O&M ratios resulting in a misleading rise in the average. Finally, we suspect that preferential rents are a more common occurrence in post-war buildings today than in 1970. The contract rents reported to HVS surveyors are rents agreed to by tenants and owners - not necessarily the highest rents authorized by law. Contract rents in 1970 may have been much closer to legal limits. If the market has taken over the higher end of this stock, the rise in the O&M ratio may reflect a relative decline in demand for luxury units. That is, in the tight market of 1970 owners may have been less likely to rent below legal limits and their relative returns would have been higher. A loss of demand at the high end is the consequence of a changing market - not rent regulation. We cannot gauge the precise effect of any of these factors on the current O&M ratio. Nonetheless, it would certainly be misleading to suggest that this rise in the O&M ratio is wholly a function of rent stabilization.

Revisiting "Table 14"

As previously noted, much of the staff's past work focused on the accuracy and usefulness of a table which compares changes in operating costs (as measured by the PIOC) with changes in rents (as measured by staff

calculations derived from guideline increases). "Table 14" (see Appendix C.3) depicts O&M ratios rising from .55 in 1970 to .74 in 1993. Several weaknesses in the table have been acknowledged for some time. Changes in the housing stock and market factors noted above have certainly affected the relationship between rents and operating costs to some degree. Yet, if these were the only weaknesses the table might remain useful as a simple measure of the relationship between legal regulated rents and operating cost changes. Even for this limited purpose, however, the table is misleading in several categorical respects. First, the rent index contained in the table fails to account for administrative rent increases (MCI's and Apartment Improvement increases) and does not adjust for rents charged below established guidelines (preferentials). Coincidentally, however, the rent index appears to have tracked contract rents in post-war buildings quite effectively. If rents in post-war buildings were \$203 in 1970 as we have suggested, the rent index projects a rise to \$662 by 1991. The 1991 HVS reported mean contract rents at \$663 for the post-war stock [not excluding stabilized units in co-ops].

The operating cost index contained in the table is more troublesome. The .55 base contained in the table reflects an estimate concerning only post-war units. As we have noted the vast majority of stabilized units (about 7 out of 10) are now in pre-war buildings which had higher O&M ratios. The cost index was adjusted (departing from the PIOC) in the 1970's in an attempt to accommodate for this influx of pre-war buildings into the stabilized sector. This attempt was misguided. As noted, the rent index reflects changes in rents initially in the post-war sector - so adjustments to the cost index to reflect the influx of pre-war units results in a one sided distortion of the changing relationship between costs and rents. If PIOC changes for post-war buildings had been left unadjusted the index

would have risen from .55 in 1971 to 222.78 in 1991 (as adjusted the index rose even higher - to 228.96). From 1969 to 1971 average operating costs in post-war buildings had risen to about \$128 per month. Updating this figure by the unadjusted index (i.e. by the PIOC for post-war buildings) to 1991 results in an average operating cost of \$519 per month - fully 10.4% higher than the \$470 figure for 1991 expenses reported by owners of post-war buildings on I&E forms, and 20.1% above the \$432 staff estimate when an adjustment for estimated over-reporting is factored in.

We believe that this difference in cost estimates reflects a tendency on the part of the PIOC to overstate actual cost increases. We continue to suspect, however, that most of this bias occurred in the 1970 - 1982 period. When USR&E conducted its operating cost survey in 1982, an average monthly cost of \$262 per unit was found in the post-war stock. Updating that figure by the PIOC for post-war buildings through 1991 results in an average cost of \$441 per month - a figure much closer to our \$432 estimate of actual costs. Note, however, that much of this period witnessed increasing investment and improvement in the city's housing stock - a time when we would not expect owners to limit maintenance and operating costs. Expenditures examined in our most recent I&E study suggest that from 1989 to 1991 actual costs rose by some 11% while the PIOC indicated a 16% rise (see page 31) - perhaps reflecting recession induced cost cutting. Since this longitudinal analysis covers only a two year period a conclusive statement on this pattern cannot be made at this time. What remains clear, however, is that **table 14, in its current form, presents a highly misleading picture of the changing relationship of operating costs to rents over time.**

Conclusions and Recommendations

A long effort to measure the impact of rent stabilization on the relationship between operating expenses and rents has resulted in some notable findings in recent years. Intricate and complex questions remain, however, and it is now evident that a clear picture may never emerge.

According to our best evidence, it presently appears that the ratio of operating costs to rent collections in the pre-war stabilized stock is about where it was twenty-five years ago. Given the passage of time and the probability of rising vacancy and collection losses, the pre-war stock seems to have achieved modest benefits transitioning to rent stabilization. Substantial evidence indicates that the ratio between operating costs and contract rents has risen in the post-war stock. The aging of that stock along with cooperative conversions and slack demand at the high end may explain much of this rise. Whatever deterioration may have occurred is clearly not as dramatic as is often charged. Recognizing the long period in which it was handicapped by inadequate information, it appears that the Rent Guidelines Board has done a remarkably effective job of immunizing owners from the effects of cost push inflationary factors while protecting tenants from demand driven rent increases. In this respect, the rent stabilization system has lived up to its mandate and continues to fulfill its purpose.

We note, however, that this analysis reflects industry averages and cannot capture the effects of stabilization on individual properties. In addition, although the impact of rent regulation on changes in the relationship between rents and operating costs may have been limited, that does not suggest that market influences on that relationship should be ignored by regulators. In the overall attempt to establish fair rents, market influences on housing viability are as critical a

concern as market influences on tenants' ability to pay. Unfortunately, the current economic environment poses an equal threat to both.

We close with one recommendation. For over four years the staff has expressed serious reservations about the usefulness and accuracy of "Table 14". Nonetheless, we remained cautious about discontinuing the table for lack of a substitute. With current longitudinal income and expense data we have constructed a new and far more reliable index, using 1989 as a base year. Except for the most recent year and the coming year, this new index measures changes in building income and operating expenses as reported in annual income and expense statements. The second to last year in the table will reflect actual PIOC increases and projected rent changes. The last year in the table - projecting into the future - will include staff projections for both expenses and rents. A copy of the proposed new index is attached.

While we believe this to be a more reliable index, it is not without limitations. First, as noted, for the past and coming year the index will continue to rely upon the price index and staff rent and cost projections. Commercial income - accounting for some 11% of average owner income - will continue to be an independent variable on the rent side. While this figure will be corrected with actual income data each year, changes for the most recent and coming year will be estimated to follow residential rents. Because of the relatively small portion of income derived from commercial units, this should not throw the projections off by any significant amount - unless, of course, the commercial market undergoes abrupt changes. Second, while the new table attempts to measure industry conditions by looking at the overall relationship between costs and income, it does not measure the specific impact of rent regulation on that relationship. Because we cannot anticipate the effects of preferential rents, MCI and individual apartment improvements for the past and coming

year, such a specific measure is impossible to develop. More importantly, the continued presence of operating costs for commercial units in the I&E data⁹, impairs our ability to precisely measure the relationship of residential rents to purely residential operating costs. If, however, the goal of the table is to broadly monitor the health of the housing stock over time, the inclusion of all building income and operating costs is a preferred indicator in any event.

Before closing we would like to note the special nature of this report. We have attempted to objectively analyze income and expense trends in

stabilized housing along with the history of policy development in this area. We also have suggested a new way of measuring future changes. These are not, however, simple administrative or ministerial matters. The ultimate determination of the relative state of the housing industry and the manner in which conditions are monitored are clearly matters which call for a legislative judgment. We hope that this report will assist the Board in making that judgment. □

⁹ Residential rents are reported separately from commercial income, but expenses relating to commercial and residential space are not separated.

Editor's Note: On June 11, 1993 the Board voted to continue reporting "Table 14" along with the new table.

Calculation of Operating and Maintenance Cost Ratio for Rent Stabilized Buildings, 1989-93

	<u>Average Monthly O&M Per d.u.*</u>	<u>Average Monthly Income Per d.u.</u>	<u>Average O&M to Income Ratio*</u>
1989.....	\$370 (\$340).....	\$56765 (.60)
1990.....	\$382 (\$351).....	\$56468 (.62)
1991.....	\$382 (\$351).....	\$55968 (.63)
1992**.....	\$400 (\$368).....	\$57669 (.64)
1993***.....	\$412 (\$379).....	\$59270 (.64)

* Operating and expense data listed is based upon unaudited filings with the Department of Finance. Audits of 46 buildings conducted in 1992 suggest that expenses may be overstated by 8% on average. See *Rent Stabilized Housing in New York City, A Summary of Rent Guidelines Board Research, 1992*, pages 40-44. Figures in parentheses are adjusted to reflect these findings.

** Expense figure includes expenses for 1991 (average expenses reported on income and expense statements filed with the Department of Finance) updated by the increase in Price Index of Operating Costs for the 4/1/92 -4/1/93 period (4.7%). Income figure includes income for 1991 (average income reported on income and expense statements filed with the Department of Finance) updated by a staff estimate based upon renewal and vacancy guidelines, choice of lease terms and estimated annual turnover rates (3.11%).

*** Expense figure includes 1992 expense estimate updated by staff projections for the period from 4/1/93 through 4/1/94 (3.1%) (Note: The projection was revised to 3.1% from 1.8% after the initial publication of this report.). Income includes income estimate for 1992 updated by staff estimate based upon renewal guidelines and choice of lease terms (2.8%).