December 12, 2017

Hon. Xavier Becerra
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Becerra:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative pertaining to rent control (A.G. File No. 17-0041).

Background

Several Cities Adopted Rent Control in 1970s and 1980s. Beginning in the early 1970s, several California cities adopted various forms of rent control (also known as rent stabilization). By the late 1980s, 14 cities—including Los Angeles, San Francisco, San Jose, and Oakland—had some form of rent control. In general, these policies limit the amount a landlord may increase the rent charged for housing from one year to the next. Allowable increases vary across cities but often are tied to an official measure of inflation. California courts have held that limitations on rent increases must not prevent landlords from receiving a "fair" rate of return on their investment. Rent control laws typically are administered by local rent boards, which are funded through fees on regulated property owners.

Costa-Hawkins Rental Housing Act Limits Local Rent Control Laws. In 1995, the Legislature enacted the Costa-Hawkins Rental Housing Act (Costa-Hawkins), which placed limitations on locally enacted rent control laws. Specifically, Costa-Hawkins prohibited local rent control rules from applying to housing first occupied on or after February 1, 1995 and single family homes. In addition, housing exempted under local rent control rules in effect at the time of Costa-Hawkins' enactment must remain exempt. Costa-Hawkins also requires local rent control rules to allow for "vacancy decontrol." This means that landlords are free to set rents to market rates when transitioning from one tenant to the next. At the time Costa-Hawkins was enacted, most rent control cities already permitted vacancy decontrol and exempted newly constructed housing from rent limitations. Several cities also exempted single-family homes.

Recently Approved Local Rent Control Measures. For many years, rent control remained limited to the handful of cities that established these rules in the 1970s and 1980s. In November 2016, voters in five communities in the San Francisco Bay Area considered measures to establish rent control. Two measures were approved, while three failed.

Research on the Effects of Rent Control. Rent control policies vary widely across California cities, as well as among cities outside of California with such policies. This variation has led to disparate research findings on the effects of rent control. For the types of policies that have prevailed in California (both before and after Costa-Hawkins), the following effects appear to be most clearly supported by empirical research:

- ***Conversion of Rental Housing to Ownership Housing.*** Owners of rental housing subject to rent control are more likely to convert their properties to condos or other forms of ownership housing. This results in fewer homes being available for rent and more being available for purchase.
- ***Reduced Rents for Housing Under Rent Control.*** Tenants in rent controlled housing tend to pay lower rent than they otherwise would. This results in more disposable income for renters and less income for landlords.
- ***Reduced Turnover Among Renters.*** Tenants in rent controlled housing are less likely to move. On the one hand, this provides stability for these renters. On the other hand, these renters may be discouraged from moving even when doing so may be beneficial. For example, a renter may be less likely to take a new job in a different location or more likely to commute further for work instead of moving.
- ***Reduced Property Values.*** The market values (the price a property could be sold for) of properties appears to decline when they are placed under rent control. Further, some evidence suggests that the market value of non-rent-controlled properties in the vicinity of rent-controlled properties also declines.

Beyond these effects, economic theory suggest that rent control policies reduce maintenance of rent controlled properties, reduce construction of new rental housing, and increase rents for housing that does not fall under rent control. It is unclear the extent to which these effects have actually occurred in practice, as some empirical research has found measurable effects while other research has found no significant effects.

Local Governments Levy Taxes on Property Owners. Local governments—cities, counties, schools, and special districts—in California levy property taxes on property owners based on the value of their property. Property taxes are a major revenue source for local governments, raising nearly $60 billion annually. Although the state receives no property tax revenue, property tax collections affect the state's budget. This is because state law guarantees schools and community colleges (schools) a minimum amount of funding each year through a combination of property taxes and state funds. If property taxes received by schools decrease (increase), state funding generally must increase (decrease).

Property Taxes Are Based on a Home's Purchase Price. Each property owner's annual property tax bill is equal to the taxable value of their property—or assessed value—multiplied by their property tax rate. A property's assessed value is based on its purchase price. In the year a property is purchased, it is taxed at its purchase price. Each year thereafter, the property's taxable value increases by 2 percent or the rate of inflation, whichever is lower. This process continues until the property is sold and again is taxed at its purchase price. In most years the market value of most properties grows faster than 2 percent per year. As a result, the assessed value of most properties is less than their market value.

California Taxes Personal Income. California levies a personal income tax on the income of state residents and on any income of nonresidents that is derived from California sources. The personal income tax is the state's largest revenue source, raising about $83 billion in 2016-17.

Sales Tax Levied for Local and State Purposes. California's local governments and the state levy a tax on retail sales of tangible goods. This tax—called the sales and use tax—is a significant source of local and state revenue. The rate varies across the state, ranging from 7.25 percent to 10.25 percent, but averages 8.5 percent statewide.

Funding Requirements for Schools and Community Colleges. Earlier propositions passed by voters generally require the state to provide a minimum amount of annual funding for schools and community colleges, known as the "minimum guarantee." The minimum guarantee tends to grow with the economy and number of students. A key input in the calculation of the minimum guarantee is state tax revenues. Reductions (increases) in state tax revenues tend to reduce (raise) funding for schools and community colleges.

Constitution Requires Minimum Annual Debt Payments and Reserve Deposits. Proposition 2 (2014) requires the state to make minimum annual debt payments and reserve deposits using a formula specified in the State Constitution. Generally, this formula is based on the size of the state's General Fund and the amount of taxes paid on capital gains.

Proposal

Repeals Costa-Hawkins. The measure repeals Costa-Hawkins. Under the measure, cities and counties can regulate rents for all types of housing regardless of age. They also can regulate how much a landlord may increase rents between tenants.

Requires Fair Rate of Return. The measure requires local rent control rules to allow landlords a "fair rate of return." This largely codifies existing case law.

Fiscal Effect

Impacts Would Depend Largely on Local Response. The repeal of Costa-Hawkins and any subsequent actions by local governments to expand the scope of rent control in California likely would increase the extent of the economic effects of existing rent control policies. More housing would fall under rent control, likely leading to more properties being devalued and/or shifted from the rental market to the ownership market. More renters would fall under rent control, likely resulting in lower rent payments for those renters and additional reductions in turnover in the rental housing market. The expansion of these effects could, in turn, impact property tax, personal income tax, and sales tax revenues.

The extent of these effects would depend primarily on what additional actions (if any) cities and counties take. Repealing Costa-Hawkins only permits cities and counties to enact more expansive rent control. Cities and counties would have to take separate actions to change their local laws. (In a few cities, local rent control laws may not have been revised to reflect Costa-Hawkins. In these cases, the repeal of Costa-Hawkins could allow these pre-Costa-Hawkins laws to take effect immediately.) It is unknown how cities and counties would respond. If few communities took subsequent actions, the effects would be limited. If, however, many cities significantly broadened the scope of their existing policies or adopted new rent control regimes, the effects would be significant. A substantial expansion of rent control in California could result in economic effects more dramatic than those suggested by research on rent control to date, including significant reductions in construction of new housing.

Reduced Property Tax Revenues. Under the measure, more property owners would face the risk and possible reality of new rent regulations. This likely would lead to a decline in the market value of these properties. This reduction in market values would be reflected in properties' assessed values over time as they are sold and reassessed to their market value. This, in turn, would reduce property tax collections for local governments. Depending on actions taken by local governments, these property tax losses could range from a few million dollars to low hundreds of millions of dollars per year.

Changes in Personal Income Tax Revenues. The measure could decrease personal income tax revenues in multiple ways. For example, landlords whose income is reduced due to new rent regulations would pay less income tax. In addition, owners of properties that are devalued by new rent regulations could earn less capital gains when selling their properties. This would reduce revenues from the taxation of these gains. Losses from rental income and capital gains taken together could range from the low tens of millions of dollars to over one hundred million dollars per year. Other factors may increase personal income tax revenues, especially over time. A significant shift in homes from the rental market to the ownership market could make it easier to find homes for purchase and more difficult to find available rentals. This could make the state more attractive to households that are able to purchase a home—who tend to have higher incomes—and less attractive to renters. Over time, this could increase the income levels of the households that move to or stay in California. This increase in household income could, in turn, lead to higher personal income tax payments. Overall, the net effect of the measure on personal income tax revenues is unclear. It is more likely than not, however, that the measure would result in a decrease in personal income tax revenues of an unknown—but potentially significant—magnitude.

Change in Sales Tax Revenues. The measure could increase sales tax revenues in several ways. For example, some renters likely would spend less on rent, allowing them to spend more on taxable goods. Some renters also may take on longer commutes to stay in rent-controlled apartments. This could increase taxable sales of new vehicles, parts, and gasoline. On the other hand, some factors could reduce sales tax revenues. For example, less rental income for landlords who reside in California could result in them spending less on taxable goods. In addition, less moving among renters could mean less taxable spending on items like furniture, home goods, moving vehicles, or meals. The measure's net effect on sales tax revenues is unclear. It is more likely than not, however, that the measure would result in an increase in sales tax revenues of an unknown—but potentially significant—magnitude.

Net Effect on State and Local Revenues. Overall, the measure would have several effects on state and local tax revenues. Some effects are very likely to lead to revenue losses, some to gains, and others are ambiguous. Reductions in revenue from taxes on property values, rental income, and capital gains are very likely and potentially significant. These are balanced by potentially significant gains in sales tax revenues. In addition, several other factors could lead to somewhat less significant increases and decreases in various tax revenues. While the net effect of all of these factors on state and local tax revenues is unclear, a net decrease appears more likely than a net increase.

Changes in Constitutional State Budget Requirements. Changes in property tax, personal income tax, and sales tax revenues could increase or decrease Constitutional requirements for school funding, reserve deposits, and debt payments. The magnitude of these potential effects is unclear.

Increased Local Government Costs. If cities with existing rent control policies elect to significantly expand the number of regulated units, they likely would face increased administrative and regulatory costs. Similarly, if other communities respond to the measure by adopting new rent control regimes, they would face new administrative and regulatory costs. Depending on actions taken by local governments, these costs could range from minimal to tens of millions of dollars per year. These costs likely would be paid by fees on owners of rental housing.

Summary of Fiscal Effects

This measure would have the following major effects:

- Unknown, but potentially significant, changes in state and local government tax revenues. Net decrease more likely than net increase.
- Potential increase in local government costs of up to tens of millions of dollars per year in the long term, likely paid by fees on owners of rental housing.

Sincerely,

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Mac Taylor
Legislative Analyst

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Michael Cohen
Director of Finance