Federal Trade Commission

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COMMISSION AUTHORIZED

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Dear Ms. Dickson:

The staff of the Federal Trade Commission is pleased to accept your invitation to comment on Int. No. 734, a proposed local law to amend the administrative code of the City of New York.[1] The bill would allow certain commercial retail and service tenants whose leases are due to expire to obtain a one-year lease extension at no more than a 15% rent increase in the event renewal terms cannot successfully be negotiated. This measure reflects an alternative to Int. Nos. 581 and 204, which are more stringent rent control proposals requiring longer term lease extensions and binding arbitration to establish renewal rents for commercial premises.

We urge rejection of all three legislative proposals, although Bill 734 is less troublesome than the other two. Rent control in any form will not promote consumer welfare and will serve only to assure that the actual demand for rental space will not be met.

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[1] This letter presents the comments of the New York Regional Office and the Bureaus of Competition, Economics and Consumer Protection of the Federal Trade Commission. The views expressed are not necessarily those of the Commission or of any individual Commissioner, although the Commission has authorized the presentation of these comments.

I. Introduction

The Federal Trade Commission is charged under 15 U.S.C. § 45 with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. Pursuant to this congressional mandate, the Commission seeks to serve the public interest and protect the marketplace from unreasonable restraints of trade. Our efforts include providing comments to federal, state and local legislative and administrative bodies to advocate competition-based approaches to various policy issues. The Commission has had a long and varied experience in analyzing the effects of price controls, including rent controls.[2] Accordingly, we offer our comments to assist you in identifying how the various legislative proposals may affect the commercial rental market in New York City.

II. Background

Three commercial rent regulation bills are currently before the City Council. The most stringent proposals are reflected in Int. Nos. 581 and 204. These bills would require mandatory lease extensions for a minimum of five years and binding arbitration to establish renewal rents for commercial tenants.[3] The most recent proposal, Bill 734, was introduced to the New York City Council at Mayor Koch's request by Council Member Jay O'Donovan on November 20, 1986. It would require that landlords engage in negotiation and non-binding mediation concerning lease renewal for certain retail and service premises, and, in the event renewal terms cannot be agreed upon, that tenants covered by the proposal have a right to a one-time one-year lease extension at no more than a 15% rent increase. We

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2 For example, the Commission staff testified before the District of Columbia Council on the proposed Rental Housing Act of 1985.

3 Int. No. 581 was introduced to the City Council by Council Member Ruth Messinger on April 10, 1986. A related proposal, Int. No. 204, had been introduced earlier by Council Member Gerges on January 22, 1986, and denominated the "Small Business Preservation Act." Proposal 204 would provide, in addition to "last offer binding arbitration" administered through a commercial rent mediation panel, that commercial tenants seeking lease renewal receive a "right of first refusal." This right, which would arise if the landlord has secured an agreement with a new tenant, would entitle the existing tenant to renew the lease by matching the rent agreed to by the prospective tenant.

understand that this proposal is intended as a transitional measure primarily to aid small merchants facing possible non-renewal of their leases.[4]

We do not believe that rent control in any form is consistent with consumer welfare, even if it is intended to be temporary in nature.[5] Rather, rent control gives rise to market distortions which have negative long-term economic consequences that may be more serious than any short-term problems it seeks to resolve. Rent control reduces market incentives to increase the supply of rental units. It ultimately works to the detriment of those sought to be aided by the legislation and produces a negative impact on the competitive environment.

As discussed more fully below, the effects of commercial rent control may include the diversion of investment capital, artificial reduction in the space available for new businesses, and deterioration of commercial rental properties. Additionally, if rent control legislation is enacted, uncertainty could exist as to whether such measures will be retained or extended, further exacerbating these market distortions. Moreover, to the extent that legislation stems from a concern for those merchants who are facing special financial hardships as a result of lease termination, a public policy response that would avoid the unintended costs associated with rent control should be considered. (See discussion in Section V.)

III. Impact of Rent Control on the New York City Economy

Rent control artificially reduces the rate of return on investments in rental space, thus reducing incentives to supply and maintain such space. Investors are likely to respond to such measures by seeking other locations or types of investment where they can expect a higher rate of return. This could adversely affect the economic growth and well-being of the city, eroding

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4 The measure applies only to retail leases where the premises do not exceed 10,000 square feet. (Int. Nos. 581 and 204, in contrast, would apply stringent regulatory measures to all non-residential leases including offices.) Bill 734 also expressly limits the scope of its requirements, containing a sunset provision that excludes from its coverage any retail lease expiring after January 1, 1992 (Sec. 22-605).

5 While our comments here are directed primarily to Int. No. 734, our views supporting a free market are equally applicable to Int. Nos. 581 and 204.

the tax base, skewing investments away from the commercial rental market, and leaving demand for such space unsatisfied.[6]

To the extent that landlords are locked-in to regulated commercial rentals, they can be expected to respond to what they perceive as a less than adequate rate of return by reducing costs. Cost reduction often takes the form of reduced maintenance or renovation. Such reductions harm the community, and work particularly to the detriment of tenants who would be willing to pay for better quality space that is unavailable in sufficient quantities. This also tends to increase costs to prospective tenants who must search longer for rental space. Shortages of rental space will deter efficient relocations and formation of new businesses.

Another problem associated with rent control relates to reduction of local tax revenues. Controlling the income earned by commercial rental property will make it less valuable. Because the land is less valuable, total tax revenues raised at a given property tax rate will be reduced.

Further, when leases expire in a context in which lease extension is required by law, some landlords can be expected to react by reducing the duration of any lease they negotiate to the minimum term permissible. In addition, where tenants have the right to mandatory lease extension, they may be able to extract lump-sum payments from landlords in return for surrendering that right. Such distorting forces not only interfere with freedom of contract, but also with the market

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6 The market distorting effects of rent control have been recognized by economists for many years, primarily in relation to residential rent control. The consensus among those who have studied the subject is that rent control in any context injures competition and consumers, imposing costs that far outweigh any benefits that some individuals receive. See, e.g., W. Block & E. Olsen (eds.), Rent Control: Myths and Realities (The Fraser Institute, 1981) (this compilation includes a chapter by T. Dienstfrey discussing residential and commercial rent control initiatives in California); C. Baird, Rent Control: The Perennial Folly (Cato Institute, 1980); Moorhouse, "Optimal Housing Maintenance Under Rent Control," The Southern Economic Journal (July 1972); Olsen, "An Econometric Analysis of Rent Control," Journal of Political Economy (Nov./Dec. 1972).

considerations that ought to govern lease negotiation. Rent control may, for instance, create an incentive for landlords to discriminate in choosing tenants, since characteristics other than a willingness to pay become more important in the relationship between the parties.[7] In addition to these undesirable effects, there are the costs associated with administering the rent regulation program, which are usually passed on at least in part to taxpayers.

Measures that would regulate price and rate of return are normally justified only if there is a general market failure such as may occur under conditions of natural monopoly.[8] There is no evidence that this is the case in the New York City commercial rental market. In the absence of regulatory control, all market participants are appropriately subject to the risks and rewards of changing conditions in which the market over time will be most efficient and effective in achieving an equilibrium between supply and demand.

Legislatures sometimes adopt rent control proposals in order to protect or assist a special class of constituents, rather than maximize consumer welfare in the aggregate.[9] Such proposals may seem appealing by virtue of the fact that most of the direct costs of rent control are borne by private parties. Rent control, however, will fail to resolve and may seriously exacerbate economic problems over the long-term. We see no persuasive justification for risking this result.

IV. Report of the Small Retail Business Study Commission

In 1985 the Small Retail Business Study Commission ("SRBSC") was convened to examine the commercial lease situation in New York City. The SRBSC's efforts resulted in a Final

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7 This effect of rent control - a tendency to encourage discrimination in the rental market - is often overlooked. It has, however, been recognized by many commentators. See, e.g., Ault, "The Presumed Advantages and Real Disadvantages of Rent Control," in Block & Olsen, supra note 6, at 61-62.

8 See, e.g., F. Scherer, Industrial Market Structure and Economic Performance 482 (1980).

9 See, e.g., Olsen & Walker, "Alternatives," at 268-69, and Dienstfrey, "The Politics of Rent Control in the United States: A Program at the Yellow Light," in Block & Olsen, supra note 6, at 6.

Report issued in June 1986 (hereafter "Final Report") reflecting the views of a majority of SRBSC Commissioners against rent control and in favor of the measures now embodied in Bill 734. A separate minority Report of the Dissenting Commissioners expressed the view that the commercial rent situation in New York City constituted an emergency that threatened the viability of many merchants[10] and warranted strong regulation (as reflected in Int. Nos. 581 and 204).

We believe that the market research undertaken by the SRBSC, which included a citywide survey of retail merchants and a survey of merchants and consumers in twelve selected city neighborhoods,[11] did not reveal an emergency warranting a broad market intrusive response. The surveys, which covered a variety of issues including merchant expectations concerning lease renewal, as well as merchant and consumer perceptions of their neighborhoods, disclosed a great deal of variation in market conditions in particular neighborhoods and divergent perceptions among both merchants and consumers of those conditions.

According to the Final Report, the surveys did not reveal a significant positive correlation between rates of merchant turnover and rent levels.[12] Turnover was comparatively low in some relatively high rent neighborhoods and comparatively high in some relatively low rent neighborhoods. Moreover, most

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10 According to the Dissenting Report, almost half of the renting merchants in New York City face a lease expiration in the years 1986-1989. However, survey results presented in the SRBSC's Final Report suggest that most such merchants expect to renew their leases. See note 13, *infra*.

11 The neighborhood survey covered retail merchants with leases due to expire in 1986, 1987 or 1988.

12 According to the SRBSC, "[i]t seems clear, in short, that recent turnover rates cannot be explained exclusively, or perhaps even primarily, by rent levels. Nor can they easily be explained by recent rates of rent increases. . . ." Final Report at II-8. The Report's "Executive Summary" further states that "because of the relative similarity of rent as a proportion of sales across the twelve [surveyed] neighborhoods, we can say that rent as a proportion of sales does not appear to be a factor in intentions to move or go out of business. Other operating costs and profit levels appear to play a bigger role." Appendix C at 12.

merchants in the twelve neighborhoods surveyed expected to renew their leases.[13] There was no indication from the survey results that there would be widespread dislocation of neighborhood merchants as a result of rent increases or non-renewal.

Regarding consumer perceptions, surveyed consumers were generally more likely than not to view retailer turnover and the entry of new stores as a positive development that enhanced the neighborhood availability of retail services without resulting in price increases.[14] Dissatisfaction with price and the availability of services was more likely to be voiced by residents of low income neighborhoods where residents and merchants face complex economic constraints and problems that cannot be linked to retail rent levels and turnover.[15] It appears that incentives for investment and long-term economic change will be far more likely to enable these neighborhoods to

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13 The SRBSC's research disclosed that only a relatively small percentage of surveyed neighborhood merchants expected to sell or go out of business, or to relocate, as a result of landlord rent demands or refusals to renew. The percentage expecting to sell or go out of business exceeded 2% in five of the twelve surveyed neighborhoods: the Upper West Side (7%), Forest Hills (5%), the East Village (4%), Riverdale (4%), and Morningside-125th Street (3%). The percentage expecting to relocate exceeded 2% in two neighborhoods: the Upper West Side (8%) and Bay Ridge (3%). See Final Report at II-3-II-4 (June 1986).

14 See Final Report at I-7, II-15-II-16.

15 The "Executive Summary" contained in the Final Report states that "if there is a problem with the accessibility of goods, it appears to be occurring in the neighborhoods not associated with gentrification (i.e., Brownsville, Morningside, and Mott Haven), where residents are significantly more likely to complain about prices. . ." See Appendix C at 16. Note that these three communities were characterized by relatively low resident income, merchant perceptions that crime is the most serious problem they face, relatively high merchant turnover, and a range of rent levels (from below the median for the surveyed neighborhoods to above) as well as a range of rates of rent increase (0%, 9% and 11% respectively over a two year period - all substantially below the neighborhood and citywide medians).

experience the benefits of revitalization than measures that maintain the status quo.[16] Moreover, the SRBSC's survey results indicated that rent and non-renewal problems are "not likely" to affect the availability of essential goods and services in any of the surveyed neighborhoods.[17]

V. Alternatives to Rent Regulation

While the overall results of the research undertaken by the Small Retail Business Study Commission indicate that most merchants expect to renew their leases, a minority of retailers, especially smaller merchants with relatively low sales volume, anticipate difficulty. To the extent that relocation is desired or necessary for some merchants, the commercial market for rental property can provide a measure of accommodation.[18] Where special assistance, however, is needed to enable merchants to relocate within the city, we believe that alternatives to rent regulation will be more efficient and cheaper in the long run than a policy resulting in diminished and deteriorated rental stock.

In its report, the Small Retail Business Study Commission recommended supply expansion measures as the most sensible means of meeting market demand. Such measures include policies that would relax zoning restrictions and authorize second story retail uses in more neighborhoods, and measures to facilitate disposition of city-owned properties to retail merchants who would provide needed neighborhood services. We support these recommendations and believe they would benefit merchants, consumers and the community at large while avoiding the anticompetitive and anticonsumer effects associated with rent control legislation.[19]

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16 See, e.g., Ault, "The Presumed Advantages and Real Disadvantages of Rent Control" in Block & Olsen, supra note 6, at 55.

17 See the "Executive Summary" contained in the Final Report, Appendix C at 8.

18 Eighteen percent of the retail businesses responding to the SRBSC's citywide survey and eight percent of those responding to the neighborhood survey had in fact moved within the past five years. See Final Report at I-11.

19 See, e.g., Olsen & Walker, "Alternatives" in Block & Olsen, supra note 6, at 276-78; see also, Scherer, supra note 8, at 485-86.

VI. Conclusions

For all these reasons, we recommend against adoption of any rent control legislation. Of the three proposals, Bill 734 entails the least intrusion into the market for commercial rental properties, but even it may be expected to produce some undesirable distortions in market operations.

We hope that your office and the City Council will find these comments of assistance in your consideration of the proposed legislation. Please feel free to contact us if you have any questions or would like further information.

Very truly yours,

Edward Manno Shumsky

Edward Manno Shumsky
Regional Director

cc: Ms. Leslie Garfield
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