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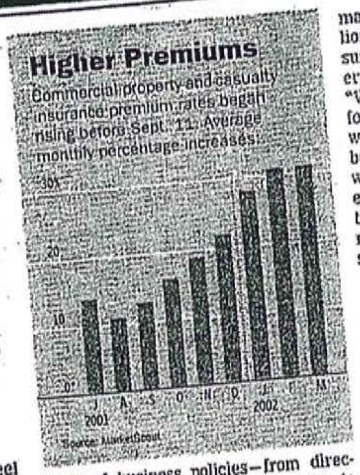
*At a Premium*

Insurance Costs Loom as a Cloud Over the Economy

Big Jumps Hit Small Firms, But Don't Blame Sept. 11; Excesses of '90s at Fault

By CHRISTOPHER OSTER

TULSA, Okla.—When Bennett Steel




types of business policies—from direc- liability coverage to

man Dean O'Hare lamented $143 million in losses the insurer suffered on surety bonds it sold to guarantee delivery of natural gas by Enron Corp. "What happened with Enron is that our folks ... didn't know what they were writing," Mr. O'Hare wrote in a December to help explain

*After Years Aloft, Manhattan's Rents Are Slowly Descending*

east need it

pain more than bigger ones. Among businesses with less than $100 million in annual revenue, about 3% of revenue to insurance, according to a study

THE WALL STREET JOURNAL.

THE PROPERTY REPORT

WEDNESDAY, APRIL 24, 2002

Apartment Owners Face Growing Liability

*Rise in Potential Dangers And Resulting Suits Send Insurance Premiums Higher*

By RAY A. SMITH

per unit with no deductible required, according to Eric Schake, a managing director with Marsh, the world's largest insurance broker, based on revenue. Marsh insures about 30% to 40% of the real-estate industry in North America. So a company with a portfolio of 5,000 units, for example, would pay a premium of $100,000. Nowadays, that cost averages $45 to $50 per unit, and requires a mini-

# RENT GUIDELINES BOARD SUBMISSION ORDER 34

**May 2002**

RSA Rent Stabilization Association

**JOSEPH STRASBURG, PRESIDENT**

**JACK FREUND, EXECUTIVE VICE PRESIDENT**

# Rent Guidelines Board Submission
# Order 34

May 2002

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**Rent Stabilization Association**

123 William Street, 14th Floor
New York, NY 10038-3814
**Tel:** (212) 214-9200, **Fax:** (212) 732-0617
**Web:** *http://www.rsanyc.org*

# SUMMARY

***The Rent Guidelines Board's Price Index of Operating Costs for 2002 showed a decrease of 1.6%. This decrease, while surprising to many, is clearly accounted for by a temporary 37% decrease in fuel costs, an unexpected 10% decrease in utility costs, and the resulting downward pressure of these components on the Index. In stark contrast, the "core" Price Index, excluding these highly unstable fuel and utility components (which have already begun to rise), measured a 5.4% increase.***

Whether by design or by coincidence, for the past decade the Board has enacted guidelines that reflect the "core" Price Index. In the past two years, when the Price Index measured operating cost increases of 7.8% and 8.7%, the Board authorized one-year renewal guidelines of just 4%. These renewal guidelines were in line with "core" Price Index increases of 3.8% and 4%. In 1995, 1998 and 1999, the Price Index showed extremely low levels of increase while the "core" Index measured increases of 2.4%, 2.3% and 2.5%, respectively. The Board again ignored the short-term fluctuations of the broader Price Index and approved 2% renewal increases based on the more realistic "core" Price Index.

The "core" Price Index, at 5.4%, has reached its highest level in ten years. The RGB staff projects another substantial increase of 5.2% in the "core" Index next year as well as a corresponding increase of 6.4% in the overall Price Index. The economic condition of the rental stock declined in 2000, with operating ratios rising and net operating income falling for the first time in years. Evidence from the Department of Finance, too, shows that building expenses were increasing faster than incomes as recently as two years ago.

Based on the recession that ensued in 2001, and the devastation wreaked on the City economy by the events of 9/11, the economic condition of the real estate industry has deteriorated further. Insurance costs have spiraled upward at an alarming rate. While rent levels and collections have been reduced, operating margins continue to contract as operating costs, including fuel at this point, increase.

Against this background, the Board should base renewal guidelines on the sobering 5.4% increase in the "core" Price Index. This year, even more so than in years past, the Rent Guidelines Board must continue to steer a level course of adjustment for renewal guidelines.

# "Core" Inflation Requires Commensurate Rent Increases

***The Rent Guidelines Board's 2002 Price Index of Operating Costs uncovers a 5.4% increase in "core" operating costs – when the highly unpredictable fuel and utility components are excluded from the market basket. Following a disturbing three-year trend of acceleration in "core" operating costs – from 3.8% in 2000 to 4% in 2001 to 5.4% in 2002 – the Board projects that "core" operating costs will continue to increase by 5.2% and overall operating costs will increase by 6.4% next year.***

This inflationary trend stands in stark contrast to the actual Price Index measurement of a 1.6% decrease, an atypical measurement that is the direct result of an unexpectedly steep decline in fuel and utility costs. The decrease in the Price Index, while unprecedented, and temporary, presents a challenge to the Rent Guidelines Board to maintain the policy it has established over the past decade of "smoothing out" the highs and lows of the price index to achieve a more level course of rate adjustment.

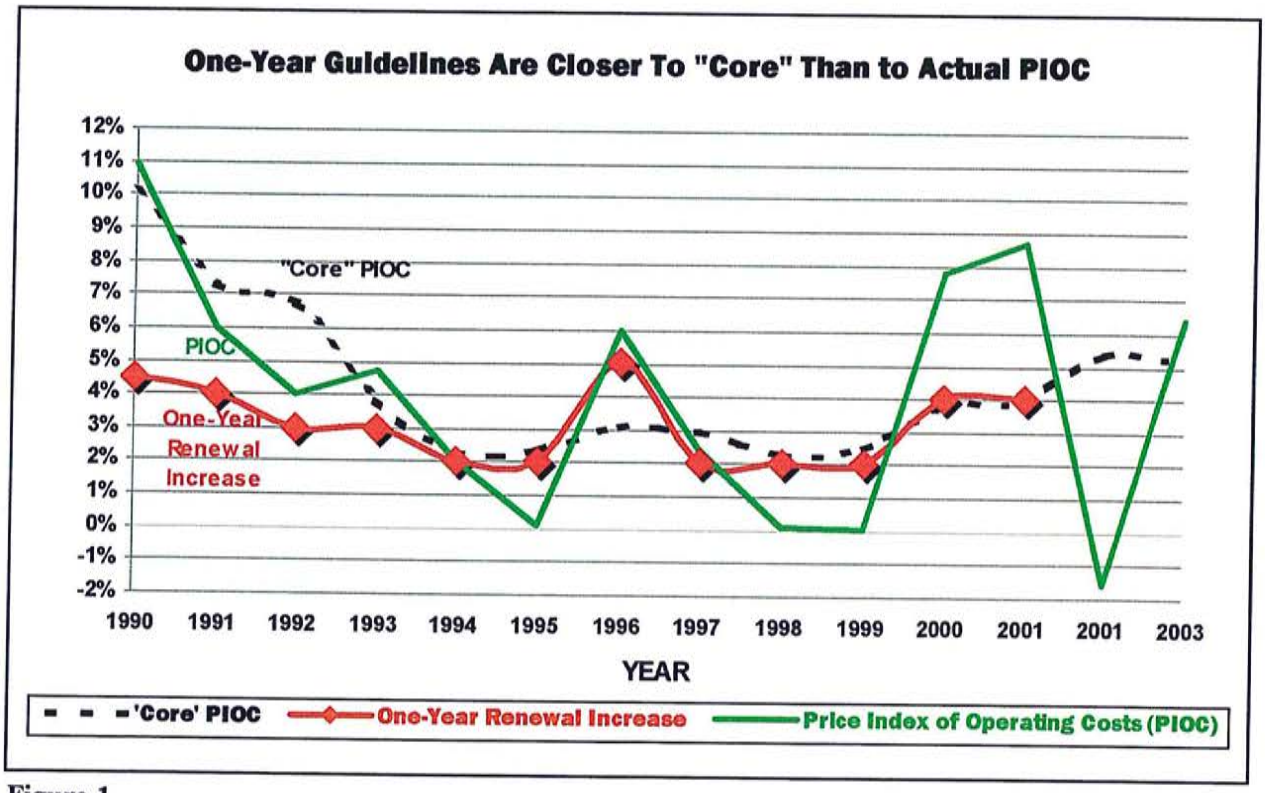


**Figure 1**
*Source: Rent Guidelines Board "2002 Price Index of Operating Costs"*

## Building Operating Costs Rising Faster than Consumer Inflation

The decade of the 1990's was marked by a benign level of inflation with regard to the overall consumer level, and specifically with regard to building operating costs. This low inflation level allowed the RGB to enact extremely moderate levels of rent increase for the middle to latter part of the decade, with one- and two-year increases typically of 2 and 4%. Perhaps not coincidentally, these increases reflected the core rate of inflation for much of the 1990's.

However, beginning with the turn of the century, increases in the costs of operating rental buildings began to outpace increases in consumer inflation by a significant margin. These substantial increases in the core inflation rate were overshadowed by even greater increases in fuel costs. Fuel costs rose by 35% in 2000 and 55% in 2001, driving the RGB Price Index to levels of 7.8% and 8.7%. But for the last two years, the RGB ignored the short-term fluctuations of the Price Index and instead pursued a level course of rent adjustment. This "smoothing" approach resulted in increases of 4% for one-year leases, roughly equivalent to the 3.8 and 4.0% rates of increase in the "core" Price Index over those years (*See Figure 1*).

This year, the unstable fuel component has moved in the opposite direction resulting in a Price Index measurement in negative territory. However, fuel prices have already begun to increase and the RGB staff projects a 17.6% increase in fuel costs next year. At same time, the "core" Price Index is at its highest level since 1992. In light of the trend of increased operating costs and the RGB staff projection that cost increases will remain high, we urge the RGB to maintain its policy of establishing rent guidelines which are in line with the "core" Price Index. This would indicate guidelines of 5% for a one-year lease and 9% for a two-year lease.

It is important to note that the past policies of the RGB have not kept owners whole with respect to increased operating costs. Between 1990 and 2001, the Price Index increased 66%, the "core" Price Index increased 64%, and one-year rent guidelines increased by only 45%. While the rent increases we are proposing this year are commensurate with past RGB policies, they are still not adequate to make owners whole (*See Figure 2*).

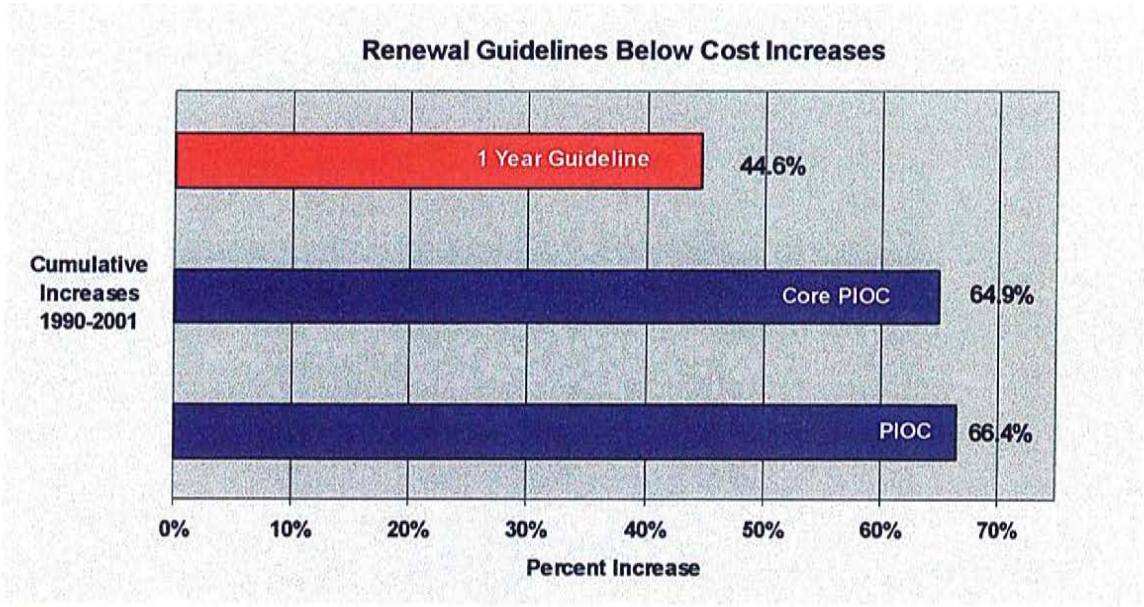


**Figure 2**
*Source: Rent Guidelines Board "2002 Price Index of Operating Costs"*

## Inadequacies of the Price Index

As the Price Index has gyrated wildly in response to swings in fuel prices, the RGB has increasingly relied on the "core" rather than the aggregate Price Index. Yet, the "core" Price Index must also be viewed with some qualification, since it shares some of the inadequacies of the Price Index as a whole. In general, these inadequacies result in underestimation rather than overestimation of operating cost increases.

Many of the failures of the Price Index result from the fact that it is no longer purely a price index. A price index, such as the Consumer Price Index, strictly measures the increase in price of a constant quantity and quality of goods and services over time. An accurate price index is updated periodically so that the weight of each item in the market basket continues to reflect an appropriate proportion of the goods and services used by the average consumer.

The RGB Price Index over time has acquired many characteristics of a cost index or expenditure survey. Such surveys attempt not only to track prices but also to capture consumption. Each approach has advantages and disadvantages when applied to a rate-

setting process for rental buildings. But it is important to understand how these distinctions can result in underestimation of real cost increases.

In a legitimate quest for accuracy, the Price Index has become increasingly polluted by a confusion of price and cost measurements affecting not only the fuel and utility components, but also the real estate tax and insurance components. The final result is a price index that tends to underestimate increases in operating costs.

For example, the Price Index measured water and sewer costs for buildings billed on a fixed frontage basis using the 3.5% rate of increase established by the Water Board. For those buildings billed on a fluctuating metered basis, the index used a consumption measure of the actual amount billed to a sample of properties, and found a 2.3% reduction in cost. The combination of these two elements resulted in a water and sewer cost increase of just 1.5%, or only half the actual rate increase.

It is extremely unlikely, however, that accounts billed on a metered basis will show such savings year after year. Any apparent decrease in costs is probably a one-time savings realized by those accounts switching from frontage to metered billing, because such a savings is the only reason to switch. Consequently, a small number of buildings measured on a consumption basis results in the majority of frontage accounts showing a smaller increase in costs than actually exists.

## Costs Not Included in the Price Index

The price index of operating costs has not been updated since 1983. In the interim, Federal, state and local governments have imposed many new maintenance and repair as well as management requirements on owners that may have changed the balance of weights in the basket. In fact, a report by an RGB consultant two years ago found that the Price Index had substantially underestimated operating and maintenance costs and administrative costs. Only because the Index overestimated other components does it appear, perhaps by coincidence, to be relatively accurate over time.

Still, the fact that various components of the Index may be over- or underestimated may result in substantial errors in any given year. The fuel component, for instance, may now bear a disproportionately high weight with a dispropor-

## Items Not Included In The Price Index:

- Local Law 10 Facade Inspection costs
- Code Enforcement Re-inspection fees
- DOH lead paint abatement costs
- DEP recycling regulation costs
- HPD annual building registration fees
- NYS DEC oil tank registration fees
- DHCR annual registration fee
- Local Law 11 of 1998
- NYC Fire Department Fire Safety Regulation
- Local Law 38 (Lead Hazard Reduction)

**Figure 3**

tionate impact regarding the production of a negative measurement in the Price Index.

Each year, RSA provides the RGB with a list of management and maintenance requirements that have been imposed by government since the Price Index was last updated (*See Figure 3*). Unfortunately, another item is usually added each year. This year, the RGB heard a discussion by an HPD representative regarding the added and ongoing costs of complying with Local Law 38, the new lead paint law. This law requires ongoing administrative and maintenance costs to manage lead paint hazards that did not exist before.

One might argue that such additional requirements do not impact on the Price Index, since it measures price increases for a constant market basket. But the Price Index is no longer a pure price index. If the Price Index can now be adjusted according to a decrease in consumption on metered water accounts, then there is no reason why consideration should not be given to the many other significant cost increases owners have had to bear that are not directly reflected in the Price Index.

### Drop In Price Index Does Not Reflect Reality

There are two major reasons to view this year's negative Price Index with some degree of skepticism. First, the measured decline in the fuel component could be exaggerated. While prices clearly declined from the prior winter to this last winter, the price decline accounts for only about half the decrease in the fuel compo-

nent. The other half of the decrease in fuel costs is based on decline in consumption measured by a proxy known as heating degree days. The heating degree day analysis is based on an anomalous situation in which a colder than normal winter is compared to a milder than normal winter.

The combination of a significant drop in prices coupled with a major variation in temperatures from one winter to the next is unlikely to reoccur and is likely to have exaggerated the actual drop in fuel costs. In addition, this year the RGB staff updated the 30-year average "normal" temperature data used as a base for computing the consumption component of fuel costs. The new "normals" reflect warmer temperatures than the prior baseline and thereby exaggerate the amount of savings based on a decline in fuel consumption.

Finally, the weight of the fuel component may be inappropriate and may therefore exaggerate the significance of the drop in fuel prices. We certainly know that fuel is a smaller component of operating costs for post-war, high-rise buildings, where taxes are a relatively more significant cost. The weight may also not be appropriate for older buildings retrofitted with new windows and fuel conservation devices. For various reasons, the majority of owners have experienced a decrease in fuel which is much smaller than that measured by the PIOC.

Second, the full increase in insurance costs does not seem to have been captured by the Price Index. Even if this year's 16.4% increase is combined with the projected increase of 16.5%, the resulting 33% increase in costs is below what most owners are reporting. The *Wall Street Journal* (April 24, 2002) reported that premiums for apartment insurance "jumped an average 60% to 70% in 2001 from a year earlier, and 50% to 100% for policies expiring at the end of 2002."

While the reasons are not clear, there is apparently a disconnect which occurs between the Price Index and reality when operating costs either increase or decrease dramatically.

# Operating Costs Increase Faster Than Incomes

***This year's Income and Expense Study reveals that rental housing profitability declined as operating costs increased faster than incomes. Department of Finance filings for calendar year 2000 show operating costs increasing by 8% while rental income rose by only 5%, resulting in an increase in operating ratios from 59% to 60%. At the same time, inflation-adjusted net operating income declined from $319 to $314. In light of underlying economic trends and recent events, there are reasons to believe that the economics of rental housing has only deteriorated further since 2000.***

Several factors distinguish the current decline in net operating income with the drop occurring in 1996. In both cases, sharp increases in fuel prices constituted a large component of the increase in operating costs. But there the similarities end.

The period in the mid- to late 1990's was characterized by relatively low levels of inflation, outside of the erratic movements of fuel costs. The core rate of inflation in the Price Index was also relatively benign, hovering in the 2-3% range. However, in 2000, the core rate of inflation in the Price Index began to accelerate, rising from 2% in 1999 to 3% in 2000, 4% in 2001 and 5.4% in the current Price Index. Further, the core rate of inflation is projected to remain high, at 5% next year.

Clearly, there is a pattern of sustained increases in core operating costs, excluding the volatile areas of fuel and utility costs, largely driven by increases in government fees including real estate taxes and water and sewer charges. But we have also seen significant increases in insurance costs that represent a new cycle in the insurance industry, one that is unlikely to subside quickly. Labor costs, contractor services and administrative costs have all also shown a pattern of increase suggesting an inflationary trend has replaced the mild levels of increase of the 1990's. In short, building operating costs are now wrapped in an inflationary cycle, at a level higher than the increase in the CPI, which shows no sign of abating.

In addition to the clear trend in operating costs, the national and regional recession compounded by the effects of September 11, 2001, have limited owners' ability to increase their rental income. It is common knowledge that the rental market was softening even before September 11, with owners offering lease renewals at the same or lower rent and offering rent concessions, free rent or payment of brokers' fees to reduce a burgeoning volume of vacancies.

While the trend of reduced rental income is not yet apparent in the 2000 Income and Expense Study, it will become clear in subsequent years' data that rental housing has entered a recessionary period with a consequent reduction in net operating income and increase in operating margins.

In light of these economic factors, the RGB must meet its mandate of preserving the viability of the housing stock by authorizing rent guidelines consistent with the increase in the "core" Price Index. While market forces may prevent owners from collecting rent increases at the high end of the market as well as at the low end, owners can collect increases through the broad middle of the market that may be sufficient to allow them to maintain and operate their buildings.

## Operating Ratios Are Higher Than Presented

Relative changes in operating ratios and net operating incomes are of principal concern and interest to the RGB. But the absolute level of these values should also be of concern as they reflect the absolute health of the rental housing market and its competitive position in comparison to the return on alternative investments, including real estate investments outside New York City.

From this perspective, a range of operating ratios with more than a 10-point differential can be derived from the income and expense data provided by the Department of Finance. Ultimately, it does not matter which of these ratios we select because they are all significantly higher than operating ratios of rental properties

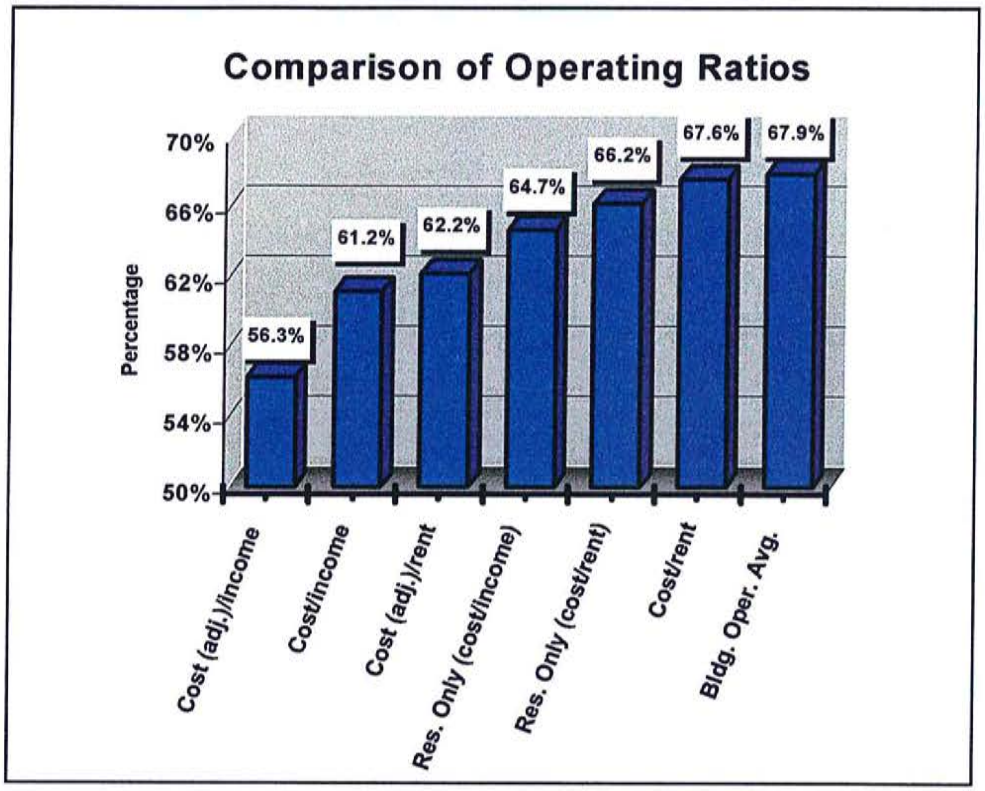


**Figure 4**
*Source: RGB 2002 Income & Expense Study - DOF raw data*

outside New York. These operating ratios range from a high of 67.9% for building average ratio for all stabilized buildings to a low 56.3% for an audit adjusted ratio for all properties including commercial income (*See Figure 4*).

There is an argument to be made that the RGB should be looking at the most restrictive definition of operating ratios, one that does not include commercial income. The RGB does not regulate or control sources of income other than rental income, and in fact the majority of regulated properties do not have income other than rental income. The true measure of how well the regulated housing stock is doing – and of how well the RGB is doing in regulating the rental stock – is the operating ratio for those buildings relying solely on rental income and RGB guideline increases. The relevant operating ratio in this sense is 67.6%.

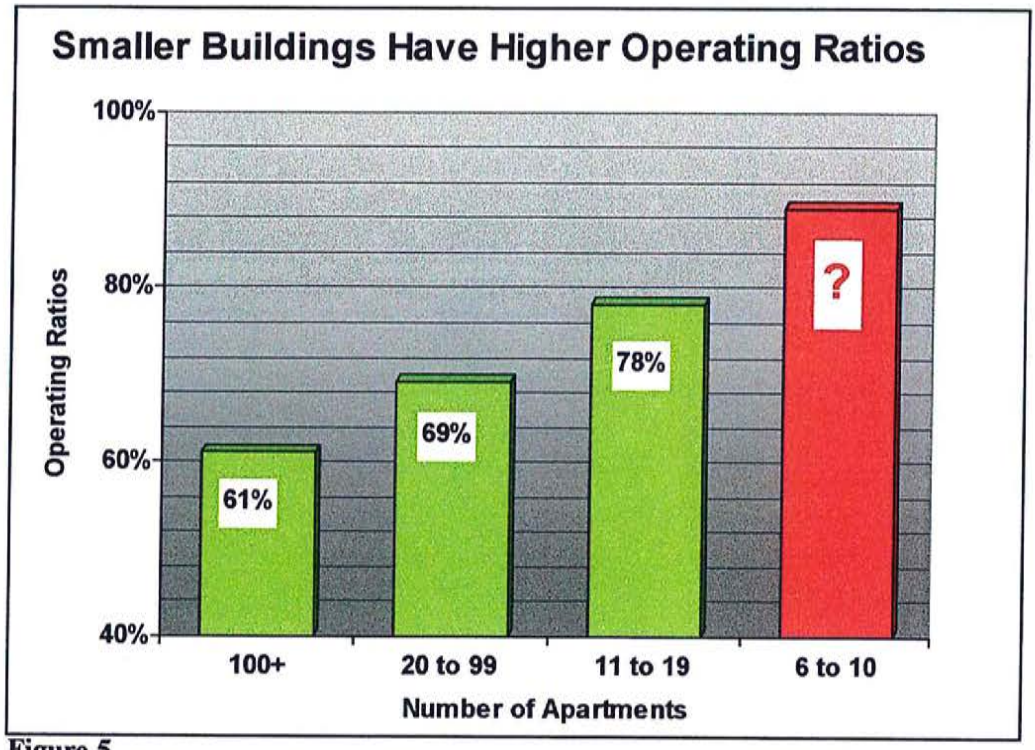


**Figure 5**
*Source: RGB 2002 Income & Expense Study - Appendix 3*

A strong argument can also be made that even the pure residential operating ratio is underestimated. That is because smaller properties, and those with assessed values of less than $80,000, are not required to file Income and Expense statements with the City's Department of Finance. Yet it is clear that these smaller properties have higher operating ratios ( *See Figure 5*). It should also be clear that if these smaller properties were included in the calculation, the overall operating ratio for residential property would be even higher.

[The issue of the audit-based adjustments of operating costs made by RGB staff will not be addressed here. Please see prior RSA Submissions to the RGB for a full discussion of why these adjustments should be discounted. An argument can also be made that the measurement methodology inappropriately biases the operating average downward because it uses an aggregate rather than a building aver-

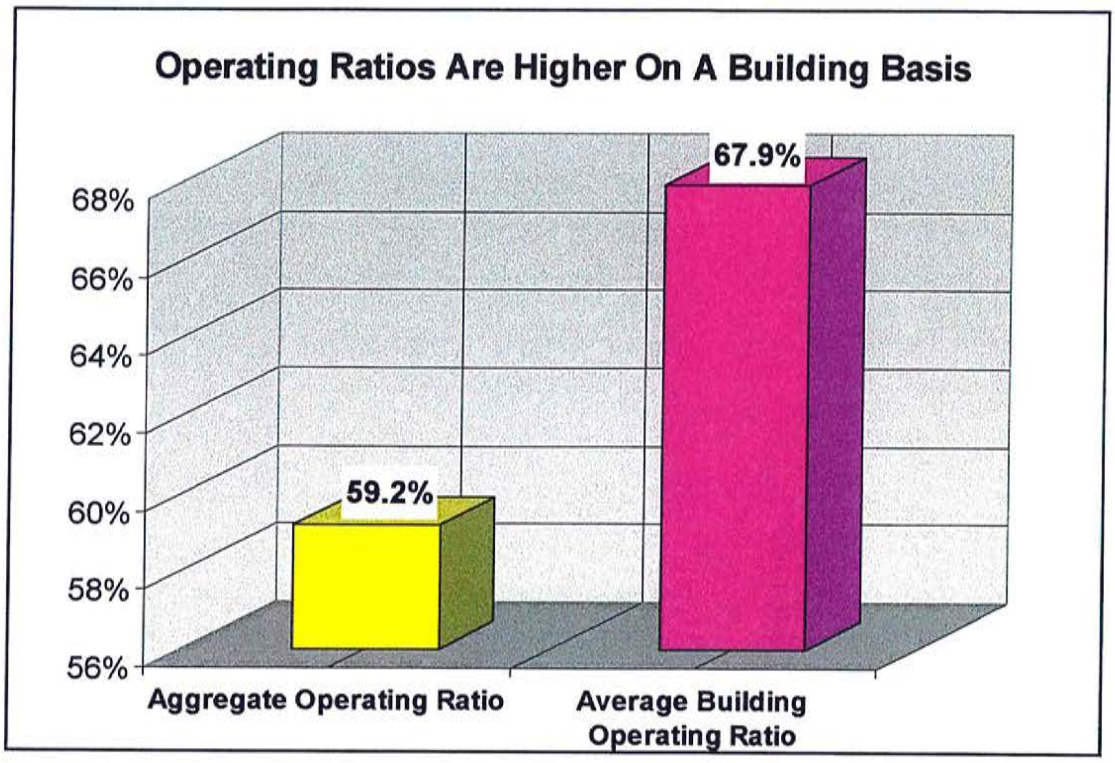


**Figure 6**
*Source: NYC Department of Finance 2000 RPIE Filing*

age. Again, prior RSA Submissions provide a more detailed discussion, but this year, for example, a 59.2% aggregate ratio would compare to a 67.9% building average ratio for all stabilized buildings. (*See Figure 6*)].

## Stabilized Net Operating Income Is Not Competitive

Although a number of possible values for operating ratios of rent stabilized buildings can be obtained, whatever value is selected will be higher than operating ratios available outside New York. At least two different national surveys of residential income and expense data reveal national and regional operating costs averages substantially lower than those prevailing in New York City. For example, according to a 2000 IREM Survey, the average operating ratio for all elevator buildings was 44.6%, compared to 61.2% for all New York City stabilized buildings including those with commercial

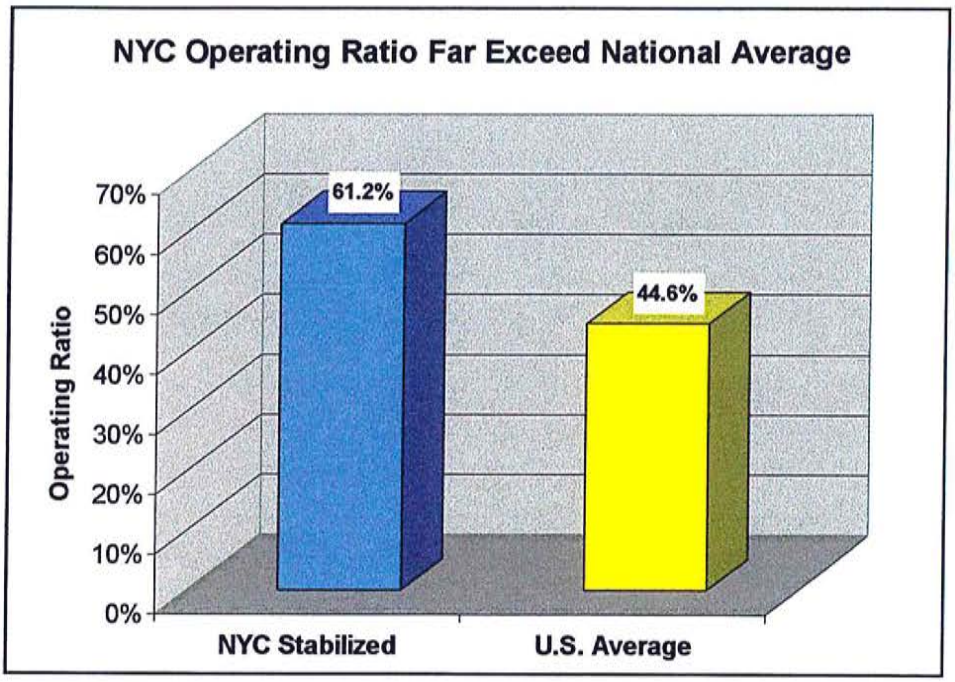


**Figure 7**
*Source:* RGB *2002 Income & Expense Study and IREM "Conventional Apartments" - 2001 Income/Expense Analysis.*

income (*See Figure 7*). This national data is illustrative only. It should be noted that national operating ratios never exceed 50% regardless of region or housing type. Perhaps the relatively low returns available on New York City properties explain why so few outside investors venture into the New York City market and why so many New York property owners look outside New York City for new investments.

# Housing Affordability

***To the extent that RGB members wish to balance the economic needs of the housing stock versus those of tenants, they should be aware that the notion of an affordability crisis has been greatly exaggerated. The notion of an affordable housing crisis in New York City is based on two perceptions: first, that one quarter of New York City renters pay more than 50% of their income for rent, and second, that middle income households cannot afford to live in New York City. Both perceptions are wrong.***

With regard to high rent burden households (those with rent to income ratios in excess of 50%), an RGB staff memo last year demonstrated that an analysis of amounts actually paid for rent (out-of-pocket or cash rent) results in a much smaller proportion of high rent households. In other words, once we take into account housing subsidies and other forms of financial assistance, the percentage of households with high rent burdens drops from 25% of stabilized renters to 15% of stabilized renters.

## Rental Burdens Exaggerated

But even the analysis of out-of-pocket or cash rent results in an exaggerated concept of the number of high rent burden households. Because of the turnover in the rent stabilized universe and the significant changes in the economic condition of households over time, the relevant question should be "what percentage of households have a sustained high rent burden over an extended period of time" rather than at just one particular point in time.

In order to answer this question we looked at the longitudinal Housing and Vacancy Survey for 1996 and 1999 and examined just those households which had been in constant occupancy of a rent stabilized apartment for that three-year period. The data shows that just 10% of rent stabilized households had high rent burdens in both 1996 and 1999. It should be noted that this calculation is based on contract rent and not cash rent. If the amount actually paid for rent were taken into account, even fewer than 10% of

stabilized households would have high rent burdens over that three-year period.

While at any given point in time, 25% of the stabilized households may have high rent burdens, a much smaller percentage, no more than 10%, have high rent burdens over a sustained period of time. The difference between the cross-sectional and longitudinal pictures can be explained by a number of factors, including turnover in the stabilized stock with lower income households moving in and higher income households moving out; changes in household composition with primary or secondary wage earners moving in or out of the household; temporary loss of employment by one or more wage earners in a household; and changes in financial assistance or housing subsidies, among other possibilities.

To place the high rent burden households into the balance of economic need, it appears that the percentage of high rent burden households is roughly equivalent to the percentage of distressed stabilized buildings (those with operating ratios in excess of 100%). Unless the economic needs of tenants are given greater weight than those of owners, the hardship cases on both sides of the equation would appear to be equal, and should therefore be factored out of consideration by the RGB.

## Housing Affordable For Middle Class

Besides the premise that there is a substantial class of hardship tenants, there is a further perception that affordability is a more broadly based phenomenon affecting middle class stabilized households, or perhaps even stabilized households as a whole. Again, this premise is exaggerated if not misplaced.

Such a perception is fostered by last year's RGB Income and Affordability Report finding that the inflation-adjusted income for stabilized renters from 1996 to 1999 actually declined by approximately half of one percent. How-

ever, studying the universe of renters who were in constant occupancy of a stabilized apartment between those years, we find that their inflation-adjusted income actually increased by nearly 3%. The difference in results is again attributable to changes in stabilized households and their conditions over time.

The universe of constant stabilized renters, rather than the cross-sectional view, is more appropriate for review by the RGB, since the purview of the RGB is to promulgate permissible levels of rent increase for renewal leases, that is, for renters who remain in occupancy. From this perspective, a number of facts about the stabilized universe look very different.

Cross-sectional data from 1991 to 1999 shows that the median stabilized rent rose from $480 to $650, an increase of 35.4%, or 4.4% per year for the eight-year period. However, the benefits of long-term tenure in a stabilized apartment are evident when we examine the universe of households who have been in continuous occupancy of the same apartment for that eight-year period. For those households, the median rent increased from $450 to $570, an increase of 26%, or 3.25% per annum for the eight-year period. In other words, the level of rent increase over this period is fully 25% less for constant households than one would expect from the cross-sectional data alone. One should also note that the median rent of $570 for constant households is more than 12% lower than the median cross-sectional rent of $650 for all households.

Looking at the universe of stabilized renters who remain in occupancy of their apartment for a long period of time, rather than taking a snapshot view of all stabilized renters at a particular point in time, a very different perception of housing affordability emerges. The percentage of tenants who have excessive rent burdens is reduced from 25% to less than 10% of all stabilized renters. Stabilized renters have also seen real gains in income over time, and the apparent level of rent increases over time is fully 25% less than might first appear.

We should also note some highlights from this year's RGB Income and Affordability Report. While the Report attempts to portray the City's renter population as racked by recessionary hardships, the data indicate that any effects of the

recession have been mild to date. For example, while there have been layoffs, employment levels are higher than at any time since 1988 and unemployment levels lower than at any time since 1989. Real, inflation-adjusted wages showed a 6% increase in 2000, continuing the gains of the 1990's. The number of households on public assistance in 2001 continued to decline and no significant change was reported in the number of Housing Court eviction actions.

In other words, while the national and regional recessions as well as the events of September 11 have undoubtedly had negative effects on the economy, New York City and its residents have, to this point, still managed to hold on to most of the significant economic gains of the 1990's.

It is important to note that the concept of housing affordability affects not just tenants but owners as well. That is, if tenants are having trouble paying the rent, then owners are having trouble generating the rental income they to need to maintain their buildings. To date, property owners have experienced decreased demand and downward price pressure primarily in Manhattan and largely for higher rent apartments. In the boroughs outside Manhattan, the housing market has remained fairly robust with some inability to raise top-end rents. Thus, the current recession appears to be a top-down recession with higher income households affected much more significantly than lower income households.

Finally, it may be that the effects of the recession are already largely behind us, at least with respect to the local economy in general. The April 24, 2002, report of the Federal Reserve found that the regional economy has strengthened since early March. Department store sales had rebounded fully to the levels seem before September 11. There were also modest improvements in the job market. Ominously for the rental housing industry, however, apartment rents remained depressed, off 15% from a year ago.

# Restore the Supplemental Adjustment for Low Rent Units

***The supplemental adjustment for low rent apartments has served as a critical tool to help property owners maintain decent living conditions for renters with low and moderate incomes. The supplemental adjustment was first instituted for rents below $200 per month upon recognition that guideline percentage increases alone, when applied to low rents, did not generate adequate revenue to support necessary housing maintenance. With a short three-year exception, the supplemental adjustment has applied to various rent levels and at different dollar amounts since 1983. The elimination of the supplemental adjustment last year now threatens the very segment of the housing stock that it was intended to serve.***

The same situation and concerns that motivated initiation of the low rent adjustment apply as much today as ever. The application of any percentage rent guideline will result in low rent apartments generating a smaller dollar amount of increase than higher rent apartments.

This situation would not be so problematic if high and low rents were distributed evenly throughout individual buildings. If that were the case, larger dollar increases for high rent units would offset lower dollar increases for low rent units in each building.

Nor would the problem be as severe if low and high rents were evenly distributed throughout the City. But low and high rent apartments are not distributed evenly. Well-defined geographic areas of low and high rents exist throughout the City.

## Low Rent Units Are Highly Concentrated

The 1999 Housing and Vacancy Survey showed that nearly one out of four rent stabilized units (23.3%, or 237,773) rented for $500 or less. At this rent level, these apartments are just above the average maintenance and operating costs for rent stabilized apartments not including mortgage costs, major capital improve-

ment requirements or profit. Again, such a large number of low rent apartments might not be such a problem if they were evenly distributed, but they are not.

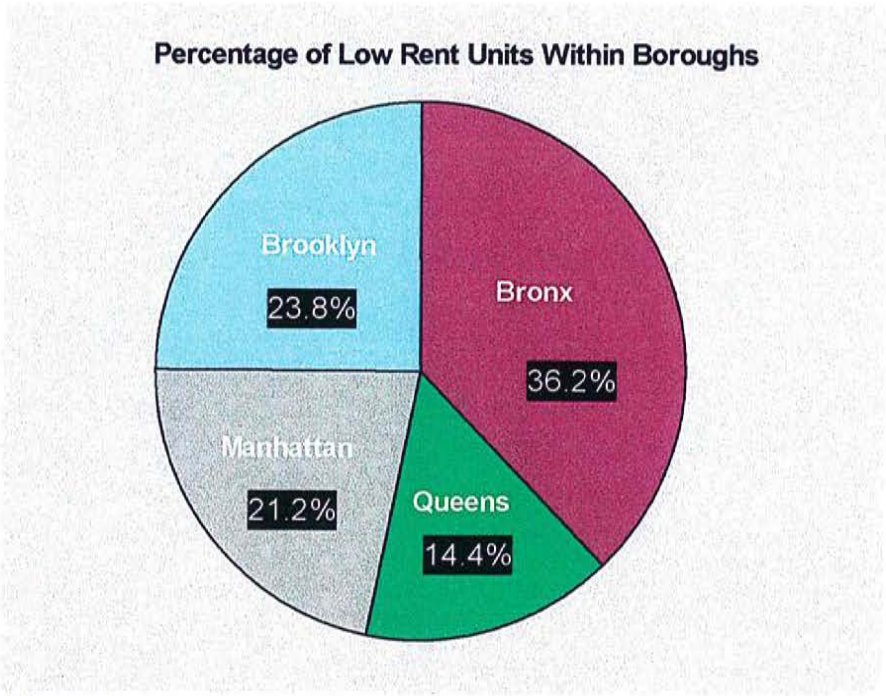


**Figure 8**
*Source: 1999 Housing & Vacancy Survey*

By borough, Queens has the fewest units with only 12% of all low rent apartments. Manhattan has the most low rent apartments with 31.7% of the total (perhaps this accounts for why Manhattan is such a bastion of rent stabilization). The Bronx follows with 28.4% of the low rent units, close to the 27.1% in Brooklyn.

While this may look like a fairly even distribution of low rent apartments among the Bronx, Manhattan and Brooklyn, the picture looks a little different when we look within the boroughs. Within each borough, the Bronx has the greatest concentration of low rent apartments with 36.2% of all its stabilized apartments in the low rent category. Brooklyn follows with 23.8% low rent units, Manhattan has 21.2% of low rent units and Queens has 14.4% of its units in the low rent category (*See Figure 8).*

The most dramatic concentrations of low rent units appear when we look at the HVS sub-borough areas. In Manhattan, for instance, 37.4% of the units are on the Lower East Side, 37.1% of the units are in East Harlem and fully 51.2% of the units in Central Harlem are low rent apartments.

While there are undoubtedly fewer apartments renting for less than $500 in 2002

than there were in 1999, operating costs have also increased in the interim and the threshold for the low rent adjustment should be increased proportionately from the $500 level. At any given point in time, there should be a low rent supplemental adjustment threshold that encompasses approximately 25% of all stabilized units.

## Low Rents Do Not Mean Low Incomes

The supplemental adjustment for low rent apartments has been characterized and criticized as a poor tax, yet no evidence to support this conclusion has ever been provided other than the generalized notion that poorer people live in lower rent apartments. Higher rent apartments do tend to be occupied by higher income households, but one of the perverse consequences of rent regulations in New York is that households become locked into place. As a result, more higher income families occupy low rent apartments.

Consider some of the unexpected facts we discover when looking at the households occupying apartments renting for $500 or less (based on data for the 1999 HVS):

- Low rent households have a median rent to income ratio of just 24%, lower than the average rent burden for all stabilized households. If these households were predominately low income they would have higher than average rent burdens.
- Only 23% of households in low rent apartment have excessive rent burdens (rent to income ratios of 50% or more).
- Nearly half of all low rent households have incomes above $17,000 per year. While this is not a large income, it should be noted that last year's RGB staff report on income and affordability characterized households earning more than $15,000 per year as middle income.
- 5% of low rent households earn more than $63,000 annually.

Another way to determine whether occupancy of a low rent apartment defines a constituency of low income households is to compare the low rent group to the

class of households which has excessive rent burdens (50% or more of income paid for rent). This comparison reveals that the excessive rent burden class has a median household income of just $8,400, approximately half the median income of the low rent group, and that the top income for the excessive rent burden class is $47,000 per year compared to incomes in excess of $64,000 for the low rent group.

In short, the evidence from the HVS indicates that the occupants of low rent apartment have lower than expected rent burdens, higher than expected incomes and are likely to be able to pay an additional rent supplement to help maintain their apartment in habitable condition.

Finally, we examined the unsupported contention that successive supplemental adjustments are forcing low rent occupants out of their apartments. To determine whether low rent occupants were more likely to move than renters as a whole, we looked at the longitudinal data for 1996 and 1999 to identify apartments which were linked in both years and rented for $400 or less in 1996, the applicable level for the low rent adjustment at that time. We then looked to see what percentage of households occupying those apartments in 1996 were still in place in 1999. 75% of the low rent apartments in 1996 were still occupied by the same household in 1999. This retention rate implies a turnover rate for low rent apartments that is less than the turnover rate of 12% for the stabilized stock as a whole.

# Guideline Proposals

## Renewal Guidelines

We urge the Rent Guidelines Board to adhere to the policy it has established over the past decade of steering a level course of adjustment based on the "core" Price Index, rather than the more erratic movements of the overall Price Index. The Board should approve one- and two-year lease renewals of 5% and 9%, in line with the increase in the "core" Price Index of 5.4%. While these guidelines are not sufficient to make up for past deficits, the rental housing industry is willing to offer such a concession in light of the current recessionary environment.

## Sublet Allowance

The RGB has allowed a sublet allowance of 5% in each of the last two years. We propose that the sublet allowance be increased to 10%.

The sublet allowance was never an issue for the RGB prior to amendments to the rent laws passed by the 1997 State Legislature because the sublet allowance under previous state law was equal to the vacancy allowance established by the RGB. With the vacancy allowance established by State law in 1997, the RGB adopted a rule to allow owners to collect a temporary rent increase for the term of a sublet. This allowance is reasonable in light of administrative costs, possible legal costs and the risk of accepting a tenancy which is not of the owner's choosing.

## The Special Guideline

The RGB is required by law to provide guidance for the New York State Division of Housing and Community Renewal when an initial stabilized rent for a formerly rent controlled apartment is challenged by a new tenant. We believe the current formulation is appropriate and should be continued.