72-5079

SHARAV, Itzhak, 1934-
NEW YORK CITY MULTIFAMILY RENTAL HOUSING WITH MORTGAGE INSURANCE UNDER SECTION 207 OF THE NATIONAL HOUSING ACT: AN ANALYSIS OF THE RECORD FOR THE YEARS 1964-1968.

The City University of New York, Ph.D., 1971
Business Administration

University Microfilms, A XEROX Company, Ann Arbor, Michigan

NEW YORK CITY MULTIFAMILY RENTAL HOUSING WITH MORTGAGE INSURANCE UNDER SECTION 207 OF THE NATIONAL HOUSING ACT: AN ANALYSIS OF THE RECORD FOR THE YEARS 1964-1968

by

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A dissertation submitted to the Graduate Faculty in Business in partial fulfillment of the requirements for the degree of Doctor of Philosophy, The City University of New York.

1971

This manuscript has been read and accepted for the Graduate Faculty in Business in satisfaction of the dissertation requirement for the degree of Doctor of Philosophy.

June 15, 1971
date

Chairman of Examining Committee

June 15, 1971
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Acknowledgements

In writing this study I received information, useful advice, suggestions and comments, some written others oral, from many individuals. I especially wish to thank Judah Gribetz, Chairman of the Conciliation and Appeals Board of the Rent Stabilization Association, Frank S. Kristof of the New York State Urban Development Corporation and Allan F. Thornton, formerly with the Federal Housing Administration. A more complete list will include Professor George Sternlieb, Director, Center for Urban Social Science Research, Rutgers University, Louis Winnick of the Ford Foundation, Marshall I. Sroge and Edward J. Lukashok, Executive Director, and Assistant Director, respectively, of the Rent Stabilization Association, Professor Chester Rapkin of Columbia University, Professor Dick Netzer of New York University, Abraham Engel of the Housing Development Administration, Joseph A. Pechman of the Brookings Institution, William h. Shron, CPA, Member, the Conciliation and Appeals Board, Julian M. Bond of the East River Savings Bank, John B. Maylott of the Federal Housing Administration, Alfred Schimel of the City Planning Commission, Maurice S. Paprin, President, Associated Builders & Owners of Greater New York Inc., and Jonathan Weiner of the Office of the Mayor, Bureau of the Budget.

I am greatly indebted to Dean Emanuel Saxe, University Distinguished Professor of Accounting, the City University of New York, and a member of my Supervisory Committee, for a tireless review of the manuscript, a thankless job which he carried out with unfailing dedication above and beyond the call of duty.

Financial support for the project was received from the City College Fund in the form of the Class of 1938-25th Anniversary Graduate Scholarship Award. Clerical help by Louise Buckley was valuable.

My wife Vera edited the manuscript, and assisted in many other ways. Her indispensible contribution is hereby greatfully acknowledged.

Itzhak Sharav

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CHAPTER I

HOUSING INVESTMENT DATA: THE NEED AND THE SHORTAGE

A. Need for Data

The case for reliable analytical data on operating expenses and profitability of multifamily rental housing in New York City can hardly be overstated. Similar intelligence has traditionally been considered a prerequisite for sound decision-making by both present and prospective investors in various industries and lines of commerce. Housing investors need such data no less than other entrepreneurs.

In recent years, however, there has been a growing demand for housing investment information from an additional source; the makers and formulators of public policy. The continuous shortage of housing accommodations, evidenced by an extremely low vacancy rate brought about fears of severe rent increases and resulted in legislative enactments which actually regulate the pricing of rental housing. The legislation is marked by the notion of permissible "fair rent increases" which are

linked to operating costs in order to preserve profits.

Several of the most recently enacted statutes in New York City clearly demonstrate the need for housing costs data. First among them is the Rent Stabilization Law.[1] The law covers multiple dwellings containing six or more units which were built since February 1, 1947 (standard rent control applies to buildings constructed earlier) and before March 10, 1969,[2] as well as certain older housing accommodations which were decontrolled by the City during the ensuing years.[3] It applies to some 408,000 of the City's 600,000 non-controlled apartments. Multi-family rental properties with mortgage insurance by the Federal Housing Administration are not excluded from coverage by the law.[4] The measure sets rents charged on May 31,1968 as a base, and directs a newly formed Rent Guidelines Board to establish a level of fair rent increase over that base, with statutory ceilings for the first year of 10 per cent for a two-year renewal lease, 15 per cent for a three-year renewal lease, 15 per cent for a two-year vacancy lease, and 25 per cent for a three-year vacancy lease.[5]

The importance of operating costs data becomes evident from the following two provisions of the law:

(1) A landlord may be granted a special rent increase upon satisfying a panel, called the Conciliation and Appeals Board, that the present income from the property consti-

tutes a hardship to him, and the definition of such hardship is inability "to maintain approximately the same ratio between operating expenses...and gross rents which prevailed on the average over the immediately preceding five-year period."[6] (2) The Rent Guidelines Board is further authorized to establish guidelines for a new level of fair increase on July 1, 1970 and once annually thereafter. These guidelines will reflect among other things operating expenses such as the "prevailing and projected (a) real estate taxes and sewer and water rates (b) gross operating and maintenance costs."[7]

The Rent Stabilization Law was subsequently extended to apply to dwelling units occupied by permanent tenants in hotels containing six or more units which were constructed by July 1, 1969 and which rented on May 31, 1968 for no more than $350.00 a month (or $88.00 a week).[8] Substantially the same consideration of fair increases based on changes in operating costs that are supposed to underlie the guidelines of the Rent Guidelines Board in the case of multifamily rental housing, were thus made applicable to residential hotels as well.

The same philosophy of adherence to operating costs in setting rent levels permeates the latest legislation which is meant to reform rent control in New York City.[9] Affected by the new plan are the great majority of the City's 1.3 million rent controlled apartments, and the

rationale behind the law is that

> a 'gap' has developed between the amount of money actually flowing into buildings from rent and the amount of money needed to maintain and improve those buildings. This gap has grown at an accelerated rate in the past few years as a result of inflation.[10]

The public policy significance of the rent plan was spelled out as follows:

> Steps to close the gap between present building revenue and necessary maintenance revenue will contribute significantly to improve large portions of the deteriorating housing stock, and are of central importance in preventing deterioration of housing that is still sound.[11]

The plan requires determination of operating costs, since it calls for the "establishment of economic rent ceilings at a level that will permit adequate building maintenance,"[12] with an annual adjustment of the ceilings "in accordance with an index reflecting operating and maintenance costs including wages, real estate taxes, and return on capital value."[13]

B. Shortage of Data

If the need for housing investment data is by now amply clear, it is nevertheless a widely recognized fact that such data are in short supply indeed. A succession of housing students, some of them pioneers who have laid the methodological foundations for housing research in the United States, have pointed to the need as well as the shortage.[14] They have been joined by public bodies

and commissions such as the National Commission on Urban Problems (the Douglas Commission) which only recently concluded that "useful data on housing costs are surprisingly scarce."[15]

C. Major Studies and Statistical Compilations to Date

Having commented on the shortage of housing investment data, one should nevertheless recognize that any present-day study of operating expenses and profitability of multifamily rental housing in New York City benefits from numerous past works. These studies may be quite dated by now. Some cover locations other than New York City; their usefulness could well be restricted because of other limitations that will be noted below. Their value, however, lies in their originality; they have provided us with the methodology of housing investment research. The analytical tools currently used have been either forged or suggested by these works. Specific references to these studies,as well as numerous other ones, are interspersed throughout this work.

In addition to the older studies there are several current publications of research projects mostly undertaken on behalf of the City of New York, and applying largely to specific segments of the housing market. Findings arrived at here are compared with these other current works as well as with earlier ones.

Grebler's study, "Experience in Urban Real Estate Investment,"[16] is without doubt a pioneering work in its field. An ambitious undertaking, it covers 581 New York City real estate properties both residential and non-residential, and where records were available, the analysis extends over half a century (from 1900 to 1950). In many cases though, due to lack of data, the period under review was shortened substantially. Grebler sought to analyze the long-term record of operating expenses and investment experience; to that end he used chain indexes which demonstrated percentage changes in revenue and expenses over time. Significant operating ratios were derived and several yardsticks were applied to measure return on capital. These devices have gained wide circulation as standard techniques in housing investment analysis.

No diminution of the value of Grebler's contribution is attempted here by drawing attention, nevertheless, to certain evident limitations of this work, some of which were in fact noted by Grebler himself,[17] while still others were pointed out by various housing students.[18] First, it should be recognized that the study concludes with 1950, and its figures therefore--aged as they are--do not reflect housing developments during the bulk of the post-war period. Perhaps an even more serious limitation is the fact that Grebler's extensive sample was not scienti-

fically selected; due to the absence of an authoritative listing of all the properties in the population, and the lack of assurance to the researchers that once properties were picked up for sampling, their accounting records would be made available to them. The sample design depended to a large extent on the willingness of property owners and managers to cooperate, and on the degree of record-keeping practiced by them. For this reason the sample consists mostly of Manhattan properties; the outlying boroughs were not accorded their proper weight. Accounting records of long-term owners and managers were relied upon to the exclusion of properties that changed hands frequently. Furthermore, such accounting records were not necessarily "certified" by independent accountants, and they may have well been non-comparable by inconsistencies in accounting procedures. It is entirely possible, for example, that the real estate tax figures include, on occasion, charges for Workmen's Compensation Insurance, as well as Social Security Taxes. It should also be recognized that Grebler did not reach beyond the computation of returns on real estate investment on a "free and clear" basis, so that the income tax shelter provided by depreciation charges, as well as the effects of high leverage through debt financing, have been ignored in this analysis.

An even earlier study of pioneering significance is the pre-war survey of apartment buildings by the Federal Housing Administration.[19] The study first developed oper-

ating trends for 96 multifamily rental properties in 5 large American cities, including New York City, for the period 1926-1935. An analysis was then made of the 1935 operating experience of 386 multifamily apartment dwellings located in 7 large cities. A rare degree of uniformity and consistency was achieved by adherence in the presentation of data to the FHA "Uniform System of Accounts for Multifamily and Group Housing Projects." Some of the main limitations, however, are the "traditional" dependence on the cooperation of willing landlords and property managers, as well as the lack of randomized sampling.

The post-war period--marked as it was by a pressing housing shortage and a growing interest of the public and public authorities in the problem--witnessed a number of significant studies.[20] New York State initiated an early post-war study[21] which contained an analysis of the 1949 operating results of 56,467 rental units in 4,908 rent-controlled buildings in various parts of the state. Since rent control in New York City was at the same time administered by the State, included in the analysis were 38,333 dwelling units in 1,698 buildings in the City. A comparative analysis for the years 1943 and 1949 was also provided and, in addition, figures were obtained for 3,398 controlled dwelling accommodations in New York City hotels. The study was, however, severely criticized for

not sufficiently representing rental ranges, and for placing too heavy an emphasis on Manhattan properties.[22]

The operating experience of several apartment buildings in a mid-western city, from 1939 through 1955, was analyzed by James.[23] His findings are useful for comparative analysis purposes, yet his is a limited sample of walk-up houses that were all built during the building boom of the 1920's. This too is--to use Winnick's term--a "grab" sample of properties that were not randomly selected, but were continuously operated by professional managers who made their records available to researchers.

Among Winnick's extremely valuable writings on housing we find his studies of (1) income and expenses of 18 Chicago apartment houses for the years 1936 to 1956, and (2) operating experience in FHA Section 608 rental projects from 1951 to 1956.[24] The Chicago study covers 18 apartment houses, nearly all of them built in the late 1920's, and continuously managed by the same concern. Winnick, like Grebler, constructed a chain index of income and expenses. The inherent limitation, however, again lies in the method of selection which was not randomized. The FHA projects were located in four standard metropolitan areas, including some 76 walk-up and elevator properties in New York-northeastern New Jersey.

Residential properties in an urban renewal area were examined by Rapkin.[25] The study covers a twenty-

block area of Manhattan's upper West Side which was marked by decline and which was designated for urban renewal under the provisions of the Housing Act of 1954. An exhaustive study, it is nevertheless restricted to a specific segment of the New York City real estate market with its unique characteristics.

The investment performance of apartment houses was compared to that of common stocks during the years 1952-1962 by Wendt and Wong.[26] Twenty FHA Section 608 rental projects, all but one located in the San Fransisco Bay Area, were not randomly selected; the 76 industrial stocks, on the other hand, were chosen at random. Another work containing data on operating expenses and profitability is Sternlieb's analysis of slum properties in Newark.[27] It is a detailed study that, similar to his more recent study of New York City rent-controlled properties to be mentioned below, investigated the myriad socio-economic problems which complicate the apartment rental market in a large, and at least partially decaying, city. Sternlieb provides operating ratios of 32 slum properties for which "complete records" were provided by a "major tenement management company" (no mention of the year).

Beginning with 1956, there has been prepared an annual compilation of income and expenses of apartment buildings in various North-American cities.[28] Operating ratios and trends are provided for both furnished and unfurnished

elevator, low-rise and garden-type buildings in selected metropolitan areas. Properties are not sampled at random; instead returned mail questionnaires, answered on a voluntary basis, serve as the source data. The "thinness" of the sample is evidenced by the inclusion of only 11 New York buildings in a recent edition (the 1968 compilation showing data for 1967).

Useful data for comparative analysis purposes are to be found in several compilations and studies that deal, however, with very specified segments of the housing market which are subject to unique conditions and problems. The annual report of the New York City Housing Authority[29] contains a "Comparative Consolidated Statement of Income and Expenses" which provides income and operating expenses for the Authority's projects on a per-dwelling-unit/per month basis. Income and expenses for housing projects under the City-financed limited profit housing companies program (Mitchell-Lama) were analyzed by Kristof.[30] The income and expenses trends for the period 1957-1967 were derived, as well as return on equity and income and expenses per room and per dwelling unit.

Recently, in the course of less than one year, New York City was treated to no less than four reports, almost all of them widely publicized, which addressed themselves to housing questions. The McKay report which appeared first,[31] reported findings and suggestions of a citizens' committee appointed by Mayor Lindsay in 1967 (in the aftermath of

a strike of apartment house employees) "to inquire into the economic problems of rental housing in New York City, particularly the impact of rent control on housing conditions, costs and availability."[32] The report presents very few figures on increases in costs of maintenance of rental housing and rental increases (the latter limited to the controlled sector), but these figures, according to the Committee, were taken from other sources (mostly from the Rand Report mentioned below); the report's contribution by way of original data is, therefore, circumscribed.

The study by Niebanck[33] is based on an analysis of the latest (1968) New York City Housing and Vacancy Survey,[34] and its relation to the topic of housing investment experience is minimal. The report does, however, contain figures on gross monthly rents, as well as rent-income ratios as of April, 1968, for controlled and non-controlled housing units.

A recent report by Rand,[35] in drawing on different studies conducted by researchers both within and outside the organization, compares the trend in controlled rents with that of maintenance and operating costs for the period 1945-1968. The cost figures were obtained through an analysis of the operating histories of 57 Federal public housing projects, and mention is made of the lack of comparable data for private rental housing.[36]

Among the latest and most widely publicized New York City sponsored studies on housing is the monumental Sternlieb report.[37] This is a study in depth of the economics of rent-controlled housing in the City. Among other things, it utilizes data that were obtained from a randomly selected sample of 963 rent-controlled structures with 30,820 apartments throughout four of the City's five boroughs (Staten Island was excluded).[38] In addition, a much smaller sample of 121 non-rent-controlled buildings was constructed for purposes of comparative analysis. The latter, however, were not randomly selected, but were rather picked on a "matched pair" basis,[39] so that only such non-rent-controlled properties were included, as were located not more than several blocks from designated rent-controlled dwellings.[40] While such a method of selection serves its purpose, namely, comparison of near-by properties--both rent-and non-rent-controlled--it does have the effect of excluding whole new sections of town in which the great majority of the buildings were constructed after 1947 and are, therefore, non-rent-controlled. A study of this newer segment of the rental market was neither intended, nor accomplished by the Sternlieb report.

The need has thus been demonstrated for a complementary study that will shed light on operating results of non-rent-controlled apartment projects in New York City. To this end, the analysis that follows is presented.

D. Scope and Plan of the Present Study

The main body of the current study is to be found in the next four chapters. Combined, they present an analysis for the period 1964-1968 of the operating results of 78 multifamily rental properties selected from a list[41] of New York City properties whose mortgages are currently insured by the Federal Housing Administration under the provisions of Section 207 of the National Housing Act.[42]

1. Sample design and characteristics of sample properties. The 78 properties were selected through systematic random sampling[43] from a population of 313 apartment buildings. A sample constituting 25 per cent of the population was constructed by the inclusion of every fourth property listed. The first property to be selected was picked up through the use of a random technique and it happened to be the fourth on the list.

It will be noted (from Table 1-1) that New York City multifamily residential dwellings with mortgage insurance under Section 207 of the National Housing Act were built in all of the five boroughs. The heaviest concentration of properties, though, is to be found in Queens and Manhattan, areas characterized by substantial construction activity in the post-World War II period. Brooklyn and especially the Bronx, on the other hand, are noted by a

TABLE 1-1

DISTRIBUTION OF FHA SECTION 207 PROPERTIES IN NEW YORK CITY BY BOROUGH

	Bronx	Brooklyn	Manhattan	Queens	Richmond	Total
Number of properties in population	31	64	102	109	7	313
Number of properties in sample	8	16	26	27	1	78

Source: FHA Section 207 sample.

significantly smaller number of Section 207 buildings, while Richmond--as expected, due to the predominance of small private homes there--ranks last among the five boroughs in its share of Section 207 multifamily rental properties. The ratio of 25 per cent between the sample and the population was maintained (as shown in Table 1-1), not only on an overall basis, but for the various boroughs as well. Such good distribution resulted from the fact that the properties on the list which was used for sample selection, were arranged by neighborhoods (e.g. Forest Hills, Riverdale, etc.).

Several major physical characteristics of the sample are listed below. Financial characteristics (e.g. rent per dwelling unit, revenues and operating expenses per room, etc.) are studied in the main body of this work (Chapters II-V). As indicated (in Table 1-2), the properties have been classified by location (Manhattan versus the outlying boroughs) and by height (six-story semi-fire-proof buildings versus so-called "highrisers," fire-proof properties in which the number of stories is at least seven). The classification by location was undertaken due to the unique desirability of Manhattan sites, while the arrangement by height of properties in the other boroughs takes cognizance of the expenses that are involved in the operation of taller structures (e.g. need for extra elevators, etc.).

According to Table 1-2, the Manhattan properties

TABLE 1-2

FHA SECTION 207 NEW YORK CITY SAMPLE--A CROSS-SECTIONAL TABULATION OF MAJOR PHYSICAL CHARACTERISTICS OF SAMPLE PROPERTIES

	Manhattan	Other Boroughs		Total
	All Highrisers	Highrisers	Six-Stories	All Boroughs: Six-Stories & Highrisers
Number of properties	26	17	35	78
Height by number of stories (range)	12-34	8-29	6	6-34
Total number of apartments	5,833	4,928	4,594	15,355
Average number of rooms per apartment	4.5	4.5	4.3	4.4

Source: FHA Section 207 sample.

(one-third of the total sample) are all highrisers, and somewhat taller than the highrisers in the other boroughs. It will also be noted that there are twice as many six-story structures in the other boroughs than there are highrisers. The preponderance of lower structures outside Manhattan is indeed widely known. The average number of rooms per apartment--between four and five--indicates suitability for family living.

2. Plan and method of analysis. The study--conducted along what may be termed "traditional lines"--commences in Chapter II with an examination of trends in operating results including revenues, operating expenses and operating income. For analysis purposes, indexes have been constructed, in which 1964--the earliest year of the five-year period--has been designated as the base year. Operating ratios for 1968 are then derived in Chapter III. This is followed in Chapter IV by a determination of 1968 revenues and operating expenses on a per unit basis. The analysis culminates in Chapter V with an examination of what is undoubtedly the crucial test of investment profitability: rates of property-, as well as equity-, return in relation to returns earned on other comparable investments during the period 1964-1968.

While considerable attention has been paid in this analysis to the sectional performance of Manhattan properties versus buildings in the other boroughs (both high-

risers and six-story structures), the emphasis is, nevertheless, on an examination of the operating results of Section 207 properties in New York City as a whole. Such an approach allows a comparison with other housing studies, none of which employed a sectional analysis. The averages for the total sample that have been derived in Chapters II through V are, therefore, with very few exceptions indicated in the text, arithmetic means of all the individual sample properties rather than weighted averages of the means of the three sample sub-sections[44] (Manhattan; other boroughs--highrisers; and other boroughs--six-stories). Furthermore, the calculation of various arithmetic means for the total sample enables us to set with relative ease lower and upper confidence limits[45] for the corresponding population means, which are of interest to investors and public policy makers alike. Considerably more strenuous statistical effort was involved in the establishment of similar confidence limits for material population ratio estimates in Chapter II, where consolidated sample figures were used in order to construct an index that would yield a determination of the rate of increase in revenues, operating expenses and operating income during the period under review.

Conclusions based on the current study and suggestions provided for further consideration by the makers of public policy are summarized in Chapter VI at the end of this work.

3. Applicability of findings. While our findings are based admittedly on data generated from the records of a sample of so-called FHA Section 207 properties, we nevertheless believe that they are largely applicable to the New York City non-rent-controlled apartment sector in general, thus helping to fulfill a need which was demonstrated earlier in this chapter. There are indeed at least two major reasons why use may be preferably made of FHA Section 207 rental projects, bearing in mind the need for a wider applicability beyond the limits of this particular legislation:

(a) Section 207 properties are representative of the New York City non-rent-controlled multifamily housing sector. While the National Housing Act has been on the books since 1934, use in earnest of Section 207 began only in the aftermath of World War II.[46] New York City FHA Section 207 properties thus happen to be of a post-1947 vintage constituting, therefore, a segment of the non-rent-controlled sector. Furthermore, they are all multifamily dwellings[47]--both the customary six-story properties as well as highrisers--and, having been built in all of the City's five boroughs, they do provide an opportunity to investigate non-rent-controlled structures varying in size as well as location. Section 207 properties are supposed to serve the wide middle-class by providing, as the Act mandates: "rental accommodations, at reasonable rents, of design and size suit-

able for family living;"[48] the particular meaning, spelled out by the Act: "families with children."[49] However, the legislative requirement of "reasonable rents" cited here did not bring Section 207 rents below the rent level attained by the never controlled housing sector--as will be shown in Chapter IV--and since property returns of Section 207 properties did not reach the allowable ceilings set up by the Federal Housing Administration--as demonstrated in Chapter V--it may be concluded that rent levels and investment returns of Section 207 buildings were influenced primarily by prevailing market forces similar to the rest of the non-controlled rental housing market in New York City.[50]

Discussions with several realtors and officials of the Rent Stabilization Association, as well as a check of the records of the latter, provided further indication that Section 207 properties can indeed serve usefully in an examination of non-rent-controlled properties in New York City. Several realtors have thus stated that: (1) market conditions--rather than government regulations--dictated rentals in "207's"; (2) the Rent Stabilization Law affected the operation of "207's" in a similar manner as that of other non-controlled properties; and (3) occupants of the "207's" were not subject to any income limitations.[51] It should also be noted that 207 properties are interspersed throughout the City in the same sections and in similar proportions as are other non-

controlled dwellings.[52]

(b) Availability and reliability of financial statements. By using FHA Section 207 properties the great obstacle of non-availability of accounting records on a regular basis is overcome. Regulations of the Federal Housing Administration require from the mortgagor "complete annual financial reports based upon examinations of the books and records."[53] A relatively high level of reliability is provided by the requirements that the annual financial report which is to be furnished "within 60 days following the end of each fiscal year"[54] be "certified to by an officer of the mortgagor"[55] after having been "prepared and certified by a Certified Public Accountant (or other person acceptable to the Commissioner)."[56] A heretofore rarely known degree of uniformity, consistency and objectivity in the use of accounting procedures is sought by the requirement that an "Accountant's Certificate"[57] be attached to the annual financial report, and that it include the following three statements:

> "(1) The books of the project are being kept in accordance with the requirements of the Federal Housing Administration.
> (2) Having examined the books and records of (name of mortgagor) and having made such tests as we consider necessary under the circumstances, we are of the opinion that the accompanying balance sheet and related statements of income and net worth present fairly the position at (insert report date) and the results of its operations, after recording all year end adjustments and actual entries for the fiscal year, in conformity with generally accepted accounting principles

> applied on a basis consistent with that of the preceding year.
> (3) I have prepared this report independently in my capacity as an Independent Accountant and I declare that I am in no way connected with the mortgagor financially or otherwise." [58]

It thus becomes evident that financial statements prepared for the use of the Federal Housing Administration[59] are unique among records kept by real estate investors in their orderliness as well as their "mandated loyalty" to generally accepted accounting principles, and hence they permit a more meaningful analysis of data as of a given date, as well as an analysis of changes over a period of time.[60]

4. Terminology. Most of the terms used in the analysis that is presented in Chapters II through V are self-explanatory. The attention of the reader is directed, however, to the meaning of the following:

(1) Gross Rent: Maximum rent income possible under conditions of full occupancy at scheduled contract rents.

(2) Vacancies (value of): The difference between gross rent and an actual lower rent income due to vacancies and concessions granted to tenants in order to induce occupancy.

(3) Revenues: The sum total of gross rent less vacancies plus other income. The latter (income from vending machines, etc.) is very minor in nature.

(4) Operating expenses: All expenses connected with the maintenance, servicing and operation of a property, such

as payroll of service personnel, repairs and maintenance, real estate taxes, fuel, insurance, etc. Excluded from operating expenses are: finance charges (interest on mortgage and mortgage insurance) depreciation, and federal income taxes.

(5) Operating income: The net of revenues less operating expenses. Also known as income on a "free and clear" basis. The return to the holders of both debt and equity interests in a property is "carved out" of operating income.

NOTES TO CHAPTER I

[1]New York City, Local Law No. 16-1969, §§yy51-1.0 et seq. (The City Record, May 13, 1969). The law adds Title yy to the New York City Charter and Administrative Code. It will be cited below as RSL.

[2]RSL §yy51-3.0a.

[3]Ibid., §yy51-3.0b.

[4]A ruling to this effect by the Federal Housing Administration was communicated in two letters to Councilman Donald R. Manes, one of the authors of the Rent Stabilization Law. See New York Times, May 27, 1969, p. 47. Also see Stoneridge Apartments Company v. Lindsay, 303 F. Supp. 677 (1969). The latter was cited by the Conciliation and Appeals Board of the Rent Stabilization Association which stated: "The fact that the mortgage is insured by the FHA does not exempt the dwelling unit from this law." See Opinion Number 634, August 27, 1970.

[5]RSL, §yy51-5.0d and e.

[6]Ibid.,§yy51-6.0c.

[7]Ibid., §yy51-5.0d.(1).

[8]New York City, Local Law No. 51-1969. (The City Record, October 15, 1969). The law amends Title yy of the New Tork City Charter and Administrative Code.

[9]For a detailed summary of Mayor Linday's newest rent bill, see "Mayor Proposes Rent Rise July 1 of More than 10%," New York Times, May 13, 1970, p. 1.

[10]Page 1 of a letter by Benjamin Altman, Deputy Administrator of Housing and Development and Commissioner of Rent and Housing Mainetance, dated May 11, 1970, transmitting the new rent program to Mayor Lindsay. The communication was attached by the Mayor to his letter to the City Council of May 11, 1970, accompanying the proposed new legislation.

[11]Ibid., p. 2.

[12] Ibid., p. 3.

[13] Ibid.

[14] "Lamentations" by housing experts about shortage of data and "exhortations" for remedial action span the whole post-war era. Leo Grebler, as always a trail-blazer, as early as 1946 decried the lack of data on real estate investment experience and the resulting dearth of analysis that would permit comparison with investments in corporate bonds and stocks. He pointed specifically to the scanty available information about the statistical proportion of real estate taxes to rent revenue. See Effect of Corporate Income Tax on Investment in Rental Housing, ed. Randolph Paul and Miles L. Colean, (New York: National Committee on Housing, 1946), pp. 134, 139. A decade later, in a classical study, Grebler emphasized the importance of recorded experience which enables us to "substitute recorded facts for untested hunches and opinions prevailing among investors as well as among the public-at-large and those who make public policy decisions." Leo Grebler, Experience in Urban Real Estate Investment, (New York: Columbia University Press, 1955), p. 4.

A similar view, though somewhat more restrictive, was taken by Anthony James, who in a widely cited study mentioned the value of data on operating experience for investors and property managers who should be able to compare their record of operation with that of the industry at large. Anthony James, "17 Years of Apartment Operating Experience," Journal of Property Management, XXII, (September, 1956), p. 4.

Another noted housing student has remarked that "reliable data on the operating experience of income real estate are in extremely short supply." Louis Winnick, Rental Housing: Opportunities for Private Investment, (New York: McGraw-Hill Book Company, Inc., 1958), p. 265.

Ernst M. Fisher, an eminent authority on housing, observed that "a great gap in knowledge of housing markets exists with respect to cost of operating multifamily rental properties." He suggested, therefore, "a cumulation of operating data" which "would be valuable to both public and private housing managers, owners, operators and financiers. It would also furnish a basis for administration of such important public measures as rent control." Ernst M. Fisher, A study of Housing Programs and Policies, (Washington, D.C.: Housing and Home Finance Agency, 1960), p. 53.

Half a decade later an observation was made once again in regard to the limited amount of information on investment and lending experience concerning multifamily rental properties. Robert Moore Fisher, "Special Economic

Aspects of Mortgages on Income-Producing Properties," an address delivered at the 12th Regional Mortgage Workshop of the American Banking Association, reprinted in Mortgage Financing Symposium, (Montclair, N.J.: The Consolidated Reporting Company, 1965), pp. 93-94.

As for New York City, Paul L. Niebanck in a study commissioned by the Housing and Development Administration, noted the following limitation: "The questions that are left unanswered are of course those whose answers depend on the kinds of data that were not available at the time of this writing. For example: Are landlords receiving a fair return?" Paul L. Niebanck, Rent Control and the Rental Housing Market--New York City 1968, (New York: Housing and Development Administration, Department of Rent and Housing Maintenance, 1970), p. 152.

In recent months though, as it will be pointed out later in this work, there has been a noted improvement in regard to housing data for New York City.

15 National Commission on Urban Problems, Building the American City, (Washington, D.C.: Government Printing Office, 1968), p. 418.

16 Grebler, Experience in Urban Real Estate Investment. (Hereinafter referred to as Urban Real Estate Investment.)

17 Ibid., Chapter I, Introduction.

18 See for example, Chester Rapkin, "Role of Real Estate Taxes in the Investment Experience of Real Property," The Appraisal Journal, XXII, (October, 1954).

19 Federal Housing Administration, A Survey of Apartment Dwelling Operating Experience in Large American Cities, (Washington, D.C.: Government Printing Office, 1940).

20 The reader should perhaps be reminded that this is mostly a review of works which provide data and analysis of housing investment experience. There are many other valuable studies that would be of major interest to any student of the housing problem, but they are excluded from this discussion in light of the criterion set forth above. To mind come important works, such as Frank Kristof's series of studies on People Housing and Rent Control in different cities in New York State, see the three publications on Buffalo, Rochester and Syracuse, published by the Temporary State Housing Rent Commission and dated April, 1956; October, 1956; and November, 1956 respectively. A fourth study (on New York City) is noted below in note 34.

Other significant contributions were made in the following two works: (1) Leo Grebler, David M. Blank and Louis Winnick, Capital Formation in Residential Real Estate: Trends and Prospects, (Princeton, N.J.: Princeton University Press, 1956), (2) Louis Winnick, American Housing and its Use, The Demand for Shelter Space, (New York: John Wiley and Sons, Inc., 1957). (Hereinafter referred to as Demand for Shelter.) The interested reader should also consult the several periodicals, such as The Appraisal Journal; The Journal of Property Management and Land Economics.

[21] Temporary State Housing Rent Commission, Survey of Residential Rents and Rental Conditions in the State of New York, (State of New York, November 1, 1950).

[22] Jules Backman, Rent Control in New York State, (Albany: Temporary Rent Commission to Study Rents and Rental Conditions, 1953), p. 66.

[23] James, "17 years of Apartment Operating Experience." (Hereinafter referred to as "Apartment Operating Experience".)

[24] Winnick, Rental Housing: Opportunities for Private Investment, pp. 265-286. (Hereinafter referred to as Opportunities for Private Investment.)

[25] Chester Rapkin, The Real Estate Market in an Urban Renewal Area, (New York: City Planning Commission, 1959). (Hereinafter referred to as Real Estate Market in Urban Renewal.)

[26] Paul F. Wendt and Sui N. Wong, "Investment Performance: Common Stocks versus Apartment Houses," The Journal of Finance, XX, (December, 1965), pp. 633-646.

[27] George Sternlieb, The Tenement Landlord, (New Brunswick: Urban Studies Center Rutgers, The State University, 1966).

[28] Experience Exchange Committee, Income Expense Analysis, 1956-1969, (Chicago: Institute of Real Estate Management of the National Association of Real Estate Boards).

[29] New York City Housing Authority, Annual Fiscal Report, December 31, (New York: 1964-1968).

[30] Frank S. Kristof, Occasional Memorandum No. 19: "Rising

Rents and Housing Costs in the City-Financed Limited Profit Housing Companies Program: 1957-1967" (New York City: Housing and Development Administration, Housing and Redevelopment Board, 1967). (Unpublished.) (Hereinafter referred to as "Rising Rents and Housing Costs".)

[31] The Mayor's Rent Control Committee, Rent Control and Its Impact on Housing in New York City, (New York: December, 1969).

[32] Ibid., pp. 1-2.

[33] Niebanck, op. cit.

[34] These surveys, which are undertaken periodically by the Bureau of the Census of the U.S. Department of Commerce under contract with the City of New York, are mandated by New York State law in order to determine the rental vacancy rate in New York City. For continuation of rent control the law requires that the existence of a housing emergency be demonstrated; this is accomplished by the surveys. Earlier surveys were analyzed in the following studies: (1) Frank S. Kristof, People Housing and Rent Control in New York City, (New York: Rent and Rehabilitation Administration, 1964), analyzing the 1962 survey and (2) Chester Rapkin, The Private Rental Housing Market in New York City 1965, (New York: Rent and Rehabilitation Administration, 1966). (Hereinafter referred to as Private Rental Market.)

[35] Rental Housing in New York City, Confronting the Crisis, Vol. I, ed. by Ira S. Lowry, (New York: The New York City Rand Institute, 1970). The preface states that the report is the first of a projected five-volume study of the City's rental housing market undertaken at the request of the Housing and Development Administration.

[36] Ibid., p. 6.

[37] George Sternlieb (with Mrs. Mildred Barry and Staff), The Urban Housing Dilemma, The Dynamics of New York City's Rent Controlled Housing, (Preliminary Draft) (New York: Housing and Development Administration, Department of Rent and Housing Maintenance, 1970). (Hereinafter referred to as Urban Housing Dilemma.)

Comments on the study are to be found in an unpublished memorandum by Frank S. Kristof, "Rent Control and the Sternlieb Report," (New York: May 12, 1970). (mimeographed)

[38]The sample constitutes approximately 2.4 per cent of the total population of some 1,267,000 rent-controlled apartments. Sternlieb, Urban Housing Dilemma, p. 56.

[39]Ibid., p. 349.

[40]Ibid.

[41]The mimeographed list was provided by the Federal Housing Adminstration in Washington, D.C. through the very kind cooperation of Allan F. Thornton, former Director, Division of Research and Statistics. It is titled "Title II Section 207 Rental Project Operations by Name and Location of Specific Project Cumulative as of March 31, 1969."

[42]A handy reference to the Act as well as to other Federal housing legislation is to be found in the following publication: Committee on Banking and Currency House of Representatives 91st Congress, 1st Session, Basic Laws and Authorities on Housing and Urban Development, (Washington, D.C.: Government Printing Office, 1969).

[43]The relative merits of systematic random sampling are discussed in any number of Statistics textbooks. Chou, for example, points out that this method is a "frequently used random plan" and that "simplicity in design is a main advantage of systematic sampling." This source does warn, however, that "systematic sampling becomes a less representative design than simple random sampling if we are dealing with populations having hidden periodicities such as a definite repetitive weekly pattern in sales." There were no periodicities whatsoever in our list. See Ya-lun Chou, Statistical Analysis with Business and Economic Applications, (New York: Holt, Rinehart and Winston, Inc., 1969), pp. 365-366.

[44]The use of a weighted mean for the total sample would not have produced appreciably different results. In testing several key variables it was found out that identical results were produced by the use of either the arithmetic or the weighted mean. Thus, for example, under both calculations the 1968 ratio of operating income to total revenues amounts to 44.5 per cent, 1968 monthly operating expenses per room consume $28.00, and the 1968 property return equals 6.96 per cent. Furthermore, an examination of the standard deviations around the means of the total sample, as computed in this study, does not disclose any

TABLE 1-3

FHA SECTION 207 NEW YORK CITY SAMPLE--A CROSS-SECTIONAL TABULATION OF STANDARD DEVIATIONS AROUND SEVERAL SAMPLE MEANS

1968 Variable	Manhattan		Other Boroughs				Total	
	All Highrisers		Highrisers		Six-Stories		All Boroughs: Six-Stories & Highrisers	
	Mean	Standard Deviation	Mean	Standard Deviation	Mean	Standard Deviation	Mean	Standard Deviation
Ratio of operating income to total revenues	46.4%	6.1	42.6%	12.1	44.0%	5.1	44.5%	7.5
Monthly operating expenses per room	$32	4.1	$28	6.6	$24	2.7	$28	5.8
Property return	7.84%	1.53	6.17%	1.82	6.66%	0.99	6.96%	1.53

Source: FHA Section 207 New York City sample.

consistent pattern of larger variability than those applicable to the three sub-sections of the sample. Using the three variables mentioned above, it will be noted from Table 1-3 that the standard deviations of the total sample did not necessarily exceed those of all three sub-sections. Thus, the Table shows a relatively large variability for highrisers in the other boroughs, which is higher than that of the total sample. Such variability suggests that in future studies, where a cross-sectional analysis is to be applied, it will be of value to test a higher percentage of other boroughs highrisers in relation to the remaining sections.

45

Two confidence probability levels have been presented in this work: 50 per cent and 80 per cent. Thus, the use of random sampling has allowed us interval estimation through the employment of conventional statistical computations. In other words, such upper and lower limits mark the range within which--one could state--the population parameter (as distinguished from the sample statistics) will probably be located. Depending on the particular level used, the latter statement could be made with either 50 per cent or 80 per cent degree of confidence.

For valuable technical statistical advice on the deviation of confidence probability levels, see William G. Cochran, Sampling Techniques, (New York: John Wiley & Sons, Inc., 1963), pp. 164-165; also pertinent is Cochran's discussion beginning on p. 214 (Populations in "Random" Order), where he points out situations in which "we would expect systematic sampling to be essentially equivalent to simple random sampling and to have the same variance."

46

Public Law 479, 73rd Cong., June 27, 1934. Congressional interest in the housing field dates back to a very modest beginning on July 20, 1892, in the form of a resolution to provide the Secretary of Labor with $20,000 in order to conduct an investigation of slums in cities of 200,000 people or more (Public Res. 22, 52nd Cong.) There was some defense housing legislation in World War I, in order to ameliorate the serious housing shortage for workers in shipyards, munitions factories, and in related industries (Public Laws 102, 149 and 164, 65th Cong.) The housing shortage of that period resulted also in rent control legislation in New York State. It was, however, only as a result of the Great Depression of 1929 that a continuous stream of legislation began to pour from Congress during the period 1932-1941 and ever since. It is widely accepted today among housing students that the legislation of the early 1930's was meant to provide a

cure for the depression no less than to supply the nation with needed housing. It was designed to stimulate a faltering housing industry and provide a greater stability in the flow of mortgage funds. In line with the philosophy and recommendations of the President's Conference on Home Building and Home Ownership (The Hoover Commission) it emphasized home ownership, yet the need for rental housing was already recognized as Section 207 of the National Housing Act indicates. A substantial housing program occured, however, only after World War II.

Several sources are available for a detailed study of the history of Federal aids to housing through legislation and other means. A concise review is provided in Subcommittee on Housing and Urban Affairs, Committee on Banking and Currency, United States Senate, Congress and American Housing 1892-1967, (Washington, D.C.: Government Printing Office, 1968). Two other useful though earlier publications are, Paul F. Wendt, The Role of the Federal Government in Housing, (Washington, D.C.: American Enterprise Association, Inc., 1956), and Ernst M. Fisher, A Study of Housing Programs and Policies. An excellent review of the subject is to be found in Chapter X ("The Role of Federal Aids") in Grebler, Blanck and Winnick, op. cit. A witty and highly personal account of the history and philosophy of the National Housing Act as well as other governmental activities of the period is provided in Mariner S. Eccles, Beckoning Frontiers, (New York: Alfred A. Knopf, 1951). For a review of governmental housing policies in several countries including the United States see The Economic Problems of Housing, ed. Adela Adam Nevitt, (New York: St. Martin's Press, 1967).

[47] Section 207(c)(3). of the National Housing Act as amended states that each "property or project may include eight or more family units." See Committee on Banking and Currency, House of Representatives, 91st Cong., 1st Session, Basic Laws and Authorities on Housing and Urban Development, p. 32.

The Federal Housing Administration implemented the above legislation in a regulation requiring housing accommodations to consist "of not less than eight rental dwelling units on one site." See regulation §207.24(a) in Federal Housing Administration, FHA Regulations, Project Mortgage Insurance, Active Programs, (Washington, D.C.: U.S. Department of Housing and Urban Development, no date), p. 12.

[48] See Section 207(b)(2) of the National Housing Act, Committee on Banking and Currency, House of Representatives, 91st Cong., 1st Session, Basic Laws and Authorities on Housing and Urban Develpment, p. 30.

[49] Ibid.

[50] Additional evidence that rent levels of Section 207 properties were determined mostly by conditions in the rental housing market--rather than by FHA regulations--was provided through disclosures that owners of FHA insured buildings, who erroneously assumed for a while that their properties were exempt from the Rent Stabilization Law, had been asking for rent increases "in some cases up to 42 per cent" prior to and immediately subsequent to the enactment of the Law. Such landlords reacted to market conditions in a rather uninhibited manner, similar to owners of other non-controlled rental housing in New York City. New York Times, May 27, 1969, p. 47.

[51] The vice-president of a large real estate management concern that operates in the non-controlled sector, stated that "the FHA did not object to rent increases on our 207's; as insurers of the mortgage they were interested in our financial success and they realized that expenses went up. The problem in the early mid-60's was that of excessive supply, and then came rent stabilization which affected all our properties, 207's and others alike." Another realtor who concurred with this assessment added, "we don't check the incomes of our 207 tenants. They pay the going rent for the kind of apartment and neighborhood they live in."

[52] Table 1-2 indicates 5,833 Manhattan based apartments in our sample, or 38.0 per cent of the sample total of 15,355, with a remainder of 62.0 per cent in the other boroughs. A check of the records of the Rent Stabilization Association shows 128,357 Manhattan dwelling units subject to rent stabilization, or 36.6 per cent, out of a city-wide total of 350,853 units.

[53] See regulation §207.19(f)(5). III in Federal Housing Administration, FHA Regulations, Project Mortgage Insurance, Active Programs, p. 11.

[54] Federal Housing Administration, Handbook of FHA Requirements Governing Fiscal Operations, Accounting, and Financial Reports for Multifamily Housing Projects (Other than Cooperative Housing) Insured under the National Housing Act, (Washington, D.C.: Department of Housing and Urban Development, October, 1966), p. 6.

[55] Regulation §207.19(f)(5). III in Federal Housing Administration, FHA Regulations, Project Mortgage Insurance, Active Programs, p. 11.

[56] Ibid.

[57] Federal Housing Administration, Handbook, p.8.

[58] Ibid., pp. 8-9.

[59] The Federal Housing Administration requires similar accounting certification for housing insured by it under various programs, in addition to Section 207 multifamily rental housing.

[60] Similar considerations were implied by Winnick in his analysis of certain FHA projects in the 1950's. Winnick, Opportunities for Private Investment, p. 120, and compare with the problems encountered by Sternlieb; such as the refusal of 50 out of 714 respondents to give operating data, owners' lack of operating data for more than one year, many cases of total absence of formal bookkeeping procedures, and lack of standardized form of analysis. Sternlieb, Urban Housing Dilemma, pp. 106, 108, and 110 respectively. A debt of gratitude is owed by the author on the other hand, to John B. Maylott, Director, New York Office, Federal Housing Administration, Department of Housing and Urban Development, for special permission to extract the necessary data for the analysis on a confidential, non-identification basis, from the financial statements files at his office. This project would not have been possible without the cooperation of Mr. Maylott and that of his aides.

CHAPTER II

TRENDS OF REVENUES AND OPERATING EXPENSES

A. Significance and Method of Trends Analysis

The analysis that follows will be pursued along two major channels: one is a comparison of changes in revenues with changes in expenses in order to determine the resulting effect on the trend of operating income; the other is a comparison of these trends with changes over time of such external factors as tenants' incomes and cost-of-living indexes. This comparative analysis should demonstrate changes in the economic well-being of tenants; but--a word of caution is due here--it will not suffice singly to indicate the effect on investors in FHA Section 207 rental housing. Such a determination can be made only upon examination of returns on investment (see Chapter V). The current analysis should, however, shed light on the trend of changes in revenues and operating expenses, thus contributing to a spirited public debate that is bound to continue as long as the New York City housing shortage lasts.

The present analysis employs indexes of revenues, operating expenses and operating income . The first of

the five years under review, 1964, was designated as a "base year," and it was thus assigned an index level of 100. Each successive year was linked to the preceding one by the use of "chain indexes."[1] An average annual increase (or decrease) for the five-year period was then computed; such average being that percentage change which when applied to 1964 base of 100, and compounded annually four times (corresponding to the four years following the base year), will result in the indicated 1968 index level. Confidence limits[2] were also calculated for the major items under analysis. It should be noted that most of these limits are extremely close to the sample statistics both at the 50 per cent and the 80 per cent probability levels, thus enabling us to apply our findings to the total New York City FHA Section 207 housing population with a relatively high degree of confidence.

B. Overall View of Changes in Revenues, Operating Expenses and Operating Income

It is evident (from Table 2-1) that during the period 1964-1968 revenues advanced at a lower average annual rate (approximately 4.7 per cent) than that posted by operating expenses (approximately 5.7 per cent). As a result, operating expenses in 1968 exceeded their 1964 level by approximately 24.6 per cent, while 1968 revenues climbed only about

TABLE 2-1

FHA SECTION 207 NYC SAMPLE-INDEXES OF REVENUES AND OPERATING EXPENSES (1964=100)

Year	Revenues	Operating Expneses
1964	100.0	100.0
1965	102.8	102.4
1966	107.0	111.2
1967	113.0	117.9
1968	120.3	124.6
Average annual increase	4.7%	5.7%
Population confidence limits for average annual increase:		
At 50% confidence probability.....	4.7-4.7%	5.6-5.7%
At 80% confidence probability.....	4.7-4.8%	5.6-5.7%

Source: FHA Section 207 NYC sample.

20.3 per cent in relation to their 1964 level.

1. Effect on operating income. The above indicated movements of revenues and operating expenses resulted in changes in operating income (as shown in Table 2-2). It will be noticed that the early part of the period (through 1966) was marked by a mild increase in the sample operating income (3.3 per cent in 1965), followed by an actual decline (1.1 per cent in 1966). In the last two years, however, the sample operating income resumed an uninterrupted growth at an accelerating rate (5.2 per cent and 7.4 per cent in 1967 and 1968 respectively); thus averaging a per annum increase of approximately 3.7 per cent for the period and the population as a whole.[3]

2. Cross-sectional analysis. The most interesting finding that emerges from a cross-sectional analysis of the data (Table 2-3) is that the spread between average annual increases in revenues and operating expenses during the period 1964-1968 has never been positive (rate of increase in revenues higher than that of expenses) for any section of the sample. Another interesting observation is that Manhattan properties (all highrisers) which enjoyed the highest average annual increase in revenues (5.6 per cent) were faced, nevertheless, with a substantial negative spread between revenues and expenses (approximately 1.3 per cent) due to a relatively high average annual increase in operating expenses which similarly exceeded the corresponding averages applicable to the other sections. The high-

TABLE 2-2

FHA SECTION 207 NYC SAMPLE-INDEX OF OPERATING INCOME (1964=100) AND PERCENTAGE CHANGE OVER THE PRECEDING YEAR

Year	Operating Income Index	Percentage Change Over the Preceding Year
1964	100.0	...
1965	103.3	3.3%
1966	102.2	(1.1)
1967	107.5	5.2
1968	115.5	7.4
Average annual increase		3.7

Population confidence limits for average annual increase:

At 50% confidence probability.....3.7-3.7
At 80% confidence probability.....3.6-3.7

Source: FHA Section 207 NYC sample

TABLE 2-3

FHA SECTION 207 NYC SAMPLE-A CROSS-SECTIONAL TABULATION OF REVENUES AND OPERATING EXPENSES INDEXES (1964=100), AVERAGE ANNUAL INCREASES AND SPREAD BETWEEN REVENUES AND OPERATING EXPENSES

	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total All Boroughs, Six-Stories & Highrisers
Revenues index for 1968	124.3	118.4	115.7	120.3
Average annual increase in revenues	5.6%	4.3%	3.7%	4.7%
Operating expenses index for 1968	130.6	119.3	123.5	124.6
Average annual increase in operating expenses	6.9%	4.5%	5.4%	5.7%
Spread between average annual increases in revenues and operating expenses	(1.3)%	(0.2)%	(1.7)%	(1.0)%
Population confidence limits for average annual increase in revenues:				
At 50% confidence probability....	5.6-5.6	4.3-4.3	3.7-3.7	4.7-4.7
At 80% confidence probability....	5.6-5.6	4.3-4.4	3.7-3.8	4.7-4.8
Population confidence limits for average annual increase in operating expenses:				
At 50% confidence probability....	6.9-6.9	4.5-4.5	5.4-5.4	5.6-5.7

TABLE 2-3
(cont'd.)

	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total All Boroughs Six-Stories & Highrisers
At 80% confidence probability....	6.8-7.0	4.4-4.6	5.4-5.5	5.6-5.7

Population confidence limits for spread between average annual increases in revenues and operating expenses:

At 50% confidence probability...	(1.3)-(1.3)	(0.2)-(0.2)	(1.7)-(1.7)	(0.9)-(1.0)
At 80% confidence probability...	(1.2)-(1.4)	(0.0-(0.3)	(1.6)-(1.8)	(0.8)-(1.0)

Source: FHA Section 207 NYC sample

risers in the other boroughs have apparently maintained no spread, or at worst a relatively narrow negative spread, not because of any high average annual increase in revenues (approximately 4.3 per cent), but due to a relatively low average annual increase in operating expenses (approximately 4.5 per cent). The largest negative spread (approximately 1.7 per cent) was posted by the six-story buildings (all in the other boroughs),due to a combination of a low average annual increase in revenues (approximately 3.7 per cent) with a much higher average annual increase in operating expenses (approximately 5.4 per cent).

From the effect of the above-mentioned movements of revenues and expenses on operating income of the different sections (shown in Table 2-4), it appears that highrisers have posted the highest average annual increase in operating income during the period 1964-1968 (approximately 4.0 per cent). On the other hand, six-story properties in the other boroughs lagged behind (approximately 1.7 per cent). The underlying factors that were responsible for this performance will be analyzed in the remainder of this chapter, commencing with the revenues trend and continuing with the trend of operating expenses.

C. The Revenues Trend

1. Factors affecting revenues. A change in revenues

TABLE 2-4

FHA SECTION 207 NYC SAMPLE: A CROSS-SECTIONAL TABULATION OF OPERATING INCOME INDEX (1964=100) AND AVERAGE ANNUAL INCREASE IN OPERATING INCOME

Year	Manhattan	Other Boroughs		Total
	All High-risers	Highrisers	Six-Stories	All Boroughs, Six-Stories & Highrisers
1964	100.0	100.00	100.0	100.0
1968	117.6	117.2	106.9	115.5
Average annual increase in operating income	4.1	4.0	1.7	3.7
Population confidence limits for average annual increase:				
At 50% confidence probability.....	4.0-4.2	4.0-4.1	1.7-1.7	3.7-3.7
At 80% confidence probability.....	4.0-4.3	3.8-4.2	1.6-1.8	3.6-3.7

Source: FHA Section 207 NYC sample

results from movements in gross rents and/or the volume of vacancies. These two operate, of course, in opposing directions: an increase in gross rents, the major factor by far, will similarly affect revenues; the latter will also increase if vacancies decrease. A decline in gross rents on the other hand, as well as growth in vacancies will reduce revenues.[4] A third factor is other income which operates similarly to gross rents, and is not discussed here because of its minimal significance.

It will be noted (Table 2-5) that the increase in revenues during the period was precipitated by the combined effect of the constant growth in gross rents as well as the steady decline in vacancies. As a result, fhe (4.7 per cent) average annual increase in revenues (Table 2-1) exceeded that of gross rent (2.8 per cent). The upward movement of sample gross rents was a modest annual change of 1.0 or 1.2 per cent in the early years, but the sample rate of change accelerated later and reached 5.3 per cent in 1968.[5]

Table 2-5 draws our attention to a most important factor which serves as a constraint on rent increases. Permission of regulatory agencies and the pushing effect of increased costs, will not in themselves be sufficient to bring about substantial rent increases unless conditions of housing market environment will permit increases. A grave housing shortage, as opposed to abundance of housing, is a powerful market factor the influence of which has been felt

TABLE 2-5

INDEXES OF GROSS RENT AND VACANCY LOSSES (1964=100) AND PERCENTAGE CHANGE OVER THE PRECEDING YEAR

Year	Gross Rent		Vacancy Losses	
	Index	Percentage change over the preceding year	Index	Percentage change (dec.) over the preceding year
1964	100.0	--	100.0	---
1965	101.0	1.0	75.8	(24.2)
1966	102.2	1.2	43.9	(42.1)
1967	106.1	3.8	30.5	(30.5)
1968	111.7	5.3	22.0	(27.9)
Average annual increase/(decrease)	2.8%		(31.5)%	

Population confidence limits for average annual increase/(decrease):

At 50% confidence probability.....2.8-2.8 (31.4)-(31.7)

At 80% confidence probability.....2.8-2.8 (31.3)-(31.8)

Source: FHA Section 207 NYC sample

constantly since the mid-1960's.[6] The annual sharp decreases in vacancy losses that continued throughout the period, had a cumulative effect, substantially reducing the availability of apartments and stimulating the rent increases which were so noticeable in 1967-1968. The primacy of the market role, thus demonstrated, allows us to consider New York City FHA Section 207 properties as an integral part of the non-controlled rental housing sector, the supervision and regulation by FHA not withstanding. More evidence to this effect will be provided upon examination of Section 207 property returns (Chapter V).

2. Comparison with other sectors of the New York City housing market during the mid-1960's. Since changes in the rent level have been long considered a most vital index of the housing market, it is of interest to examine how rent increases under review here fare in comparison with other increases that have been recently observed: it is apparent (from Table 2-6) that rent increases have been common to all sectors of the housing market; but the higher average annual increases during the period 1964-1967 occurred, interestingly enough, in the controlled sector: 2.2 per cent per annum for the total controlled sample, according to Sternlieb, and an even higher rate, according to the same source--2.5 per cent per annum--for that portion of the controlled sector which closest resembles FHA Section 207 properties, namely, the newer (post-1929) and larger (50

TABLE 2-6

COMPARISON OF DIFFERENT RENT INDEXES (1964=100)
AND PERCENTAGE CHANGE OVER THE PRECEDING YEAR

Year	Consumer Price Index - Rent		Sternlieb-Rent-Controlled Dwellings (All Sets)		Sternlieb-Rent-Controlled Dwellings (Post 1929, 50 Units or more)		FHA Section 207 NYC Sample	
	Index	Percentage change over the preceding year	Index	Percentage change over the preceding year	Index	Percentage change over the preceding year	Index	Percentage change over the preceding year
Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9
1964	100.0	--	100.0	--	100.0	--	100.0	--
1965	101.6	1.6%	102.6	2.6%	103.6	3.6%	101.0	1.0%
1966	103.2	1.6	104.2	1.6	105.9	2.2	102.2	1.2
1967	105.3	2.0	106.9	2.6	107.8	1.8	106.1	3.8
1968	108.1	2.7	--	--	--	--	111.7	5.3
Average annual increase (1964-1967)	1.7%	--	2.2%	--	2.5%	--	2.0%	--
Average annual increase (1964-1968)	2.0	--					2.8	--

Sources: Column 2-U.S. Department of Labor, Bureau of Labor Statistics Consumer Price Index, New York, N.Y.: Rent-Series C-1.01 (figures converted from 1957-59 base to 1964 base)
Column 4-Sternlieb, The Urban Housing Dilemma, op.cit., pp. 315,316 (figures converted from 1967 base to 1964 base by considering the 1964 index level to equal 100.)
Column 6-Ibid, pp. 332 (figures were converted from 1967 base to 1964 base).
Column 8-Table 2-5

TABLE 2-6
(cont'd)

Technical comment: The Consumer Price Index is based on a sample of both rent-controlled and non-rent controlled properties (approximately 50 per cent rent-controlled) in a 17-county metropolitan area including the 5 boroughs of New York City, Nassau-Suffolk and Westchester-Rockland Counties in New York State as well as 8 counties in Northeastern New Jersey. New York City dwellings constitute approximately three-fourths of the sample.

units or more) buildings. Admittedly, the Consumer Price Index exhibits an average annual rate for 1964-1967 which is the lowest of all: 1.7 per cent per annum, but as has been pointed out by several authorities[7], the CPI may well tend to understate rent increases.

The "sluggishness" of the non-rent-controlled market during the period 1964-1967, as evidenced by its relatively slow rate of rent increases in comparison with increases in the controlled sector,[8] has already been noticed by Niebanck (his comparison extended over the period 1965-April, 1968). Table 2-7 confirms Niebanck's observation and, furthermore provides a clue as to the reason: we notice a drastic increase in rent of FHA Section 207 sample properties in 1968 (5.3 per cent per annum) which far exceeds the corresponding CPI figure, 2.7 per cent (Sternlieb's figures, unfortunately do not extend beyond 1967, and Niebanck's analysis is based on the Housing and Vacancy Survey of April 1968).[10] In other words: owners of FHA Section 207 properties and the rest of the non-rent-controlled housing market in New York City--burdened as they were with a legacy of high vacancies in the early 1960's--had to wait until 1967-1968 to make the substantial adjustments in rent levels, which landlords of controlled properties--much less inflicted with vacancies even in the early 1960's--were carrying out all along, within the confines of the rent control law.[11] By 1968, all leases--that were signed in 1965, and, prior to that year, under the

TABLE 2-7

RENT (GROSS INCOME) INDEX OF NYC ELEVATOR APARTMENT HOUSES
(1947-1949=100)

Year	Index	Average Annual Percentage Increase/ (Decrease)
Column 1	Column 2	Column 3
1921	115	
1924	134	
1921-1924		5.2%
1925	139	
1929	144	
1925-1929		0.9
1930	134	
1934	87	
1930-1934		(10.2)
1935	85	
1939	89	
1935-1939		1.2
1940	86	
1944	87	
1940-1944		0.3
1945	91	
1949	103	
1945-1949		3.1

Technical comment regarding Column 3: The average annual increase/(decrease) is that percentage change which, when applied to the index of the earliest year in each time period specified in Column 1, and compounded annually, will yield the index level of the latest year for that particular period per Column 2.

Sources: Columns 1 and 2: Grebler, Experience in Urban Real Estate investment, op. cit., p.232; Column 3: Computed from Column 2.

lingering conditions of a construction boom-- had expired, and new leases began to reflect the full impact of rising housing expenses, and a rapidly declining vacancy rate accompanying an acute housing shortage.

3. Comparison with New York City rental properties in the past. Placed in a wider historical context, the rate of growth of rent income of FHA Section 207 apartment houses, as well as that of other segments of the rental housing market (indicated in Table 2-6), has fallen below the extraordinary rate that marked elevator apartment houses (and the rest of the housing market) during the early years of the remarkable real estate boom of the 1920's.

Table 2-7 reveals that during the four-year period, 1921-1924, such properties registered a rate of average annual rent increase of 5.2 per cent; almost twice the FHA Section 207 rate of 2.8 per cent per annum for the period 1964-1968. Subsequent to the 1920's, a depression and a global war resulted in a rent decline and in a rent freeze, respectively. A brisk demand for housing by veterans was reflected in a resumption of rent increases, the average annual rent increase during the years 1945-1949 was 3.1 per cent, which once again was not matched by FHA Section 207 properties in the mid-1960's. Examining the movement of income, has led Grebler to refer to the first three decades of this century "as a kind of 'golden age' for [the] real estate investments."[12]

A repetition of those first three "golden" decades did not occur during the first decade of the second half of the century: one of the few available indexes of income and expenses for New York City properties in the 1950's, Winnick's study of FHA Section 608 elevator properties, shows a very modest increase in gross income, from 95.9 in 1951 to 103.2 in 1955--an average annual increase of 1.9 per cent.[13]

4. Comparison with rental properties outside New York City. Comparing FHA Section 207 New York City properties with the figures of Wendt and Wong (for FHA Section 608 San Francisco Bay Area projects), shows that FHA Section 207 New York City properties registered an average annual rent increase during the mid-1960's which was less than that achieved by the San Francisco Bay Area projects during the decade 1952-1962. Using 1952 as a base year, the gross rent of the West Coast properties stood at 122 in 1957, an increase of 4.1 per cent per annum; reaching 144 by 1962, an increase of 3.4 per cent per annum;[14] as opposed to the FHA Section 207 rate of 2.8 per cent increase.

It appears, therefore, that when judged in a wider context of income experience of other residential properties, over several decades both in and out of New York City, during the period 1964-1968, FHA Section 207 apartment houses exhibited a modest rate of average annual rent increases; the rate was particularly low in the early part of the

period, but increased significantly during 1967, and especially during 1968, as the cumulative effects of a severe housing shortage began to be fully felt. Attempts to "catch up" belatedly with increased expenses are a familiar phenomenon in the real estate industry, and are due to its elements of unique rigidity (long duration of leases, etc.) which prevent a more relaxed method of upward casual rent adjustments in response to changes in expenses. Once again, it should be noted that our data suggest that market forces were more instrumental than governmental regulation and supervision, in controlling rent increases of New York City FHA Section 207 properties. (See earlier analysis of "Factors affecting revenues" in this chapter, as well as the examination of property returns in Chapter VI.)

5. Comparison with other price and income changes. How did rent in FHA Section 207 apartments change in comparison to other price and income changes that took place during the period 1964-1968? Table 2-8 reveals an interesting development: FHA rent changes trailed CPI changes during the early years, but by 1967-1968 substantial rent changes had compensated for the earlier lag, causing both trends to approximate one another for the period as a whole: 2.8 per cent average annual increase in FHA rents versus 2.9 per cent average annual increase in CPI. Rent changes under review have almost, though not fully, kept up with in-

TABLE 2-8

COMPARISON OF FHA SECTION 207 (NYC SAMPLE) RENT INDEX WITH THE CONSUMER PRICE INDEX FOR NEW YORK (1964=100)

Year	FHA Section 207 NYC Sample-Index	Consumer Price Index-All Items
Col. 1	Col. 2	Col. 3
1964	100.0	100.0
1965	101.0	101.6
1966	102.2	105.0
1967	106.1	107.7
1968	111.7	112.3
Average annual increase	2.8%	2.9%

Population confidence limits for average annual increase:

At 50% confidence probability.....	2.8%
At 80% confidence probability.....	2.8%

Sources: Column 2-Table 2-5
Column 3-U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index, New York, New York: All items-Series A-01 (Figures converted from 1957-59 base to 1964 base)

creases in the cost of living as measured by the CPI; analyzed in such a context these rent changes cannot be considered inflationary.

A comparison of the rent changes with increases in hotel room rates was also undertaken, in order to determine how different shelter activities which are offered for sale, rose in prices in relation to each other: it will be noted (in Table 2-9) that at all times--the years 1967 and 1968 included--the annual percentage increase in hotel room rates by far surpassed that of the FHA Section 207 properties, resulting in an average annual increase for the period 1964-1968, of 4.8 per cent for hotel room rates, well above the 2.8 per cent rate for the FHA Section 207 apartments. Allowing for the fact that rates in residential hotels may have risen in a somewhat slower pace than those of transient hotels, due to the element of rigidity introduced by the presence of leases in the former, it would still seem that the rate of rise in rents of residential hotels could not lag materially behind advances made by other members of the hotel industry. If that were indeed the case, then the attraction of apartment buildings as an alternative to residential hotels in New York City grew during the period 1964-1968, thus contributing to additional demand for, and an increased shortage of, apartments.

Since housing expenses are probably the largest

TABLE 2-9

COMPARISON OF FHA SECTION 207 (NYC SAMPLE) RENT INDEX WITH NEW YORK CITY HOTEL ROOM RATES INDEX
(1964=100)

Year	FHA Section 207 NYC Sample		Hotel Room Rates	
	Index	Percentage over over the preceding year	Index	Percentage change over the preceding year
Col. 1	Col. 2	Col. 3	Col. 4	Col. 5
1964	100.0	--	100.0	--
1965	101.0	1.0%	102.1	2.1%
1966	102.2	1.2	106.3	4.1
1967	106.1	3.8	111.7	5.1
1968	111.7	5.3	120.5	7.9
Average annual increase		2.8		4.8

Population confidence limits for average annual increase:
At 50% confidence probability.....2.8-2.8
At 80% confidence probability.....2.8-2.8

Sources: Column 2: Table 2-5
Column 4: Laventhol Krekstein Horwath & Horwath, Hotel Operations: 1968-37th Annual Study, p. 31 (figures were converted from 1929 base to 1964 base by considering the 1964 indexes level to equal 100). Figures available for transient hotels only.

expense item in a family budget it is of high interest to compare rental increases and changes in tenants' income. According to Table 2-10 the average annual increase in rentals (3.4 per cent) fell below the increase in tenants' income (which amounted to 4.0 per cent per annum). The data suggest, therefore, that tenants of the never controlled rental housing sector in New York City--of which FHA Section 207 properties form a part--have not suffered, and perhaps even benefited, to the extent that their shelter expenses by 1968 consumed a lesser portion of their income than they did in 1964. This development is in marked contrast to the trends that were manifested in the controlled sector, where annual rent increases approximating 2.0 per cent or more, were accompanied by an increase in the median income of tenants, from approximately $5,200 in 1965 to $5,400 in 1968,[17] an annual increase of 1.3 per cent. The conclusion that the rent pressure had indeed increased among average-income tenants in the controlled sector, where increases in income lagged behind rent changes, while the opposite happened to average-income tenants in the never controlled rental housing sector,[18] is supported by further comparative analysis of census data for 1965 and 1968. If a gross rent-income ratio below 25 per cent is considered a reasonable one, while a ratio of 25 per cent and above may be excessive, working

TABLE 2-10

COMPARISON OF FHA SECTION 207 (NYC SAMPLE) RENT INDEX (1964=100) WITH CHANGES IN TENANTS' INCOME

Year	FHA Section 207 Sample - Index	Median Income of Tenants (never-controlled sector)
Col. 1	Col. 2	Col. 3
1965	101.0	$ 8,800
1968	111.7	9,900
Average annual increase	3.4%	4.0%

Sources: Column 2-Table 2-5
Column 3-Niebanck, Rent Control and the Rental Housing Market. op. cit., pp. 93-94 (The Median income of tenants in the never-controlled sector was used here in the absence of specific income figures for tenants of FHA Section 207 properties. The assumption that incomes of such tenants did not rise in a dissimilar manner to that of tenants' incomes in the rest of the never-controlled rental housing sector is a reasonable one since New York City FHA Section 207 properties do indeed constitute an integral part of the never-controlled rental housing sector in the City as shown earlier in this chapter and in Chapter I as well. The above assumption was also supported by several realtors.[16] For other supporting census data see Text.)

a hardship on the tenant, the following statistics will indicate that in the controlled sector there was a noticeable increase between 1965 and 1968, in the percentage of tenants burdened with an excessive ratio: the percentage increased from 34.05 in 1965 to 38.20 in 1968, while the percentage of tenants with a reasonable ratio correspondingly declined from 65.95 in 1965 to 61.80 in 1968. In the never controlled sector on the other hand, there was a slight decline in the percentage of tenants marked by an excessive ratio: 36.20 in 1965 as compared with 35.30 in 1968, and a corresponding minor increase in the percentage of tenants with a reasonable gross-rent income ratio: 63.80 in 1965 as compared with 64.70 in 1968.[19]

6. Cross-sectional analysis. A cross-sectional analysis (Table 2-11) shows that rents rose the most in Manhattan: approximately 3.7 per cent per annum, well above the total sample rate (2.8). The increase in rents in the other boroughs was much more modest, approximately 2.2 and 2.1 per cent for highrisers and six-stories, respectively, which points to the extreme desirability of Manhattan in the eyes of many tenants and apartment seekers.

This picture is confirmed by the trend of vacancy losses: the locational attractiveness of Manhattan dwellings--despite the noticeable rent increases--drove down vacancy losses there at a steeper rate per annum (37-38) than anywhere else. It is interesting to note that highrisers in

TABLE 2-11

FHA SECTION 207 NYC SAMPLE--A CROSS-SECTIONAL TABULATION OF INDEXES OF GROSS RENT AND VACANCY LOSSES (1964=100) AND AVERAGE ANNUAL INCREASES/ (DECREASE)

	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total All Boroughs Six-Stories & Highrisers
Gross rent-1964 index	100.0	100.0	100.0	100.0
1968 index	115.6	109.2	108.6	111.7
Average annual increase	3.7%	2.2%	2.1%	2.8%
Population confidence limits for average annual increase:				
At 50% confidence probability.....	3.6-3.7	2.2-2.2	2.1-2.1	2.8-2.8
At 80% confidence probability.....	3.6-3.8	2.2-2.3	2.0-2.1	2.8-2.8
Vacancy losses-				
1964 index	100.0	100.0	100.0	100.0
1968 index	15.2	27.7	23.8	22.0
Average annual (decrease)	(37.6)%	(27.5)%	(30.2)%	(31.5)%
Population confidence limits for average annual (decrease):				
At 50% confidence probability.....	(37.4)-(37.7)	(27.3)-(27.6)	(30.0)-(30.3)	(31.4)-(31.7)
At 80% confidence probability.....	(37.1)-(38.0)	(27.2)-(27.7)	(29.9)-(30.4)	(31.3)-(31.8)

Sources: FHA Section 207 NYC sample

the other boroughs witnessed a milder decline in vacancy losses (27-28) as compared to six-story apartment houses (approximately 30), despite the fact that highrisers usually offer more luxury features; a degree of "buyers' resistance" is detected here, tenants will apparently tolerate rent increases and high rents more readily in Manhattan than in the other boroughs which are considered only as a "second best." Thus, through the medium of vacancy losses and allowances--the effect of which is to reduce actual, effective rents--a mechanism is provided which lets tenants' wishes be echoed in an adjusted level of rentals.

D. The Trend of Operating Expenses

1. Comparison with the Consumer Price Index. The period 1964-1968 is noteable because of a very substantial average annual increase in operating expenses of FHA Section 207 properties: 5.6-5.7 per cent (Table 2-1). A comparison with changes in the Consumer Price Index (Table 2-12) reveals that overall inflationery pressures--as reflected by the CPI--help to explain only in part the rise in operating expenses: the average annual increase in the latter--5.6-5.7 per cent--was almost double that of the CPI, 2.9. Examination of year-to-year changes will also show that at all times during the period 1964-1968, percentage changes in operating expenses exceeded those in the CPI.

TABLE 2-12

INDEXES AND PERCENTAGE CHANGES OVER THE PRECEDING YEAR OF OPERATING EXPENSES AND OF THE CONSUMER PRICE INDEX-ALL ITEMS (1964=100)

Year	Operating Expenses		Consumer Price Index New York, New York-All Items	
	Index	Percentage Change over the preceding year	Index	Percentage Change over the preceding year
Col. 1	Col.2	Col. 3	Col. 4	Col. 5
1964	100.0	--	100.0	--
1965	102.4	2.4%	101.6	1.6%
1966	111.2	8.6	105.0	3.3
1967	117.9	6.0	107.7	2.6
1968	124.6	5.7	112.3	4.3
Average annual increase		5.7%	--	2.9%

Population confidence limits for average annual increase:
At 50% confidence probability.....5.6-5.7
At 80% confidence probability.....5.6-5.7

Sources: Column 2-Table 2-1
Column 3-Computed from Column 2
Column 4-Table 2-8
Column 5-Computed from Column 4

This observation points at the existence of special factors whose impact on the level of operating expenses of New York City rental properties is strongly felt. We will have to direct our attention to these forces later in the following analysis.

2. Comparison with other sectors of the New York City housing market. The increase in operating expenses confirmed here has affected both the public and the private apartment rental market in New York City; references to "spiraling costs" can often be heard during testimonies at various hearings by public bodies, and they find their way, of course, into the daily press.[20] It is interesting to note that the FHA Section 207 figure of 5.6-5.7 per cent per annum average increase in operating costs, comes remarkably close to Rand's finding that in New York City during the whole post-war period, 1945-1968, "the cost of supplying well-maintained rental housing has risen at an average rate close to 6 per cent per year."[21] The latter figure has also been accepted and cited by the McKay report.[22]

The Sternlieb study[23] enables us to conduct a comparison between expense increases in rent-controlled properties and such increases in FHA Section 207 apartment houses. Sternlieb found that between 1965 and 1967 operating expenses (excluding repairs and maintenance) in controlled buildings "increased nearly 10 per cent," an average annual increase of less than 5 per cent (yet this increase was

more than double the rate of increase in rents).[24] According to Sternlieb, repairs and maintenance expenses remained stable in terms of dollar figures during this period.[25] Section 207 properties, on the other hand, faced much higher increases during the same period: 8.6 per cent in 1966 and 6.0 per cent in 1967 (Table 2-12). The fact that rent-controlled properties witnessed a lower increase in operating expenses than that experienced by owners of FHA Section 207 buildings, who are at greater liberty to increase rents than landlords of controlled properties, lends support to the claim that one response to rent control may be an attempt to cut (or arrest the growth of) operating expenses.[26]

3. Comparison with New York City rental properties in the past. The annual increase in operating expenses of 5.6-5.7 per cent emerges as extremely steep when compared with available data for New York City properties during the pre-war period (Table 2-13). Not even during the real estate boom days of the early 1920's did the increase (2.6 per cent) approach half of the current rates; in the late 1920's there was a moderate annual increase (1.1 per cent) and subsequently, during the depression and the war years, operating expenses actually decreased or remained at a standstill.[27] In the post-war era, however, we much more frequently witness heavy increases in operating expenses which approximated, or even exceeded, the current rate

TABLE 2-13

TOTAL (OPERATING) EXPENSES INDEX OF NEW YORK CITY ELEVATOR APARTMENT HOUSES (1947-1949=100)

Year	Index	Average Annual Percentage Increase/(Decrease)
Col. 1	Col. 2	Col. 3
1921	86	
1924	93	
1921-1924		2.6%
1925	92	
1929	96	
1925-1929		1.1%
1930	93	
1934	83	
1930-1934		(2.8)%
1935	87	
1939	87	
1935-1939		0.0%
1940	88	
1944	88	
1940-1944		0.0%
1945	85	
1949	103	
1945-1949		4.9%

Technical comment regarding Column3: The average annual increase/(decrease) is that percentage change which, when applied to the index of the earliest year in each time period specified in Column 1, and compounded annually, will yield the index level of the latest year for that particular period per Column 2.

Sources: Columns 1 & 2: Grebler, Experience in Urban Real Estate Investment, op. cit., p. 232.
Column 3: Computed from Column 2.

of 5.6-5.7 per cent. Thus, according to Grebler's data (Table 2-13), the annual increase during the first post-war half-decade amounted to 4.9 per cent.

4. Comparison with properties outside New York City. The phenomenon of increases in operating expenses was not unique to New York City, it was borne out by studies of rental properties in other major cities: thus, Wendt and Wong in their study of San Francisco properties established that operating expenses increased from 100 in the base year 1952 to 122 in 1957, an annual increase of 4.1 per cent,[28] while the annual rise for the next five-year period was even steeper--7.5 per cent, so that by 1962 the index stood at a high of 175.[29]

5. Flexibility of operating expenses. Observation of the movement of operating expenses in the past,[30] has led some to refer to them as "stable,"[31] or to conclude that they possess a limited degree of flexibility, which is especially demonstrated in times of large declines in revenues, when operating expenses may decrease only minimally.[32] A closer analysis of Grebler's figures, however, shows that the alleged inflexibility of operating expenses in times of declining revenues, was much more noticed in the case of walk-up apartment houses than in the case of elevator rental properties[33]; for the evident reason that the latter are more luxurious dwellings where services in relative abundance are provided, but tend to be curtailed in times of reduced re-

venues; no such latitude in operations is available to the owner of a walk-up building which provided only bare minimum amenities in the first place, and he does not have, therefore, the wide range of services which could be narrowed in bad times.

FHA Section 207 properties in New York City, as well as other non-rent-controlled apartment buildings, being of a relatively modern "vintage" and being allowed rent increases more freely than controlled properties, would naturally offer more amenities than those to be found in the controlled sector. It is of particular interest, therefore, to investigate patterns of behavior of major operating expense items in the face of general increases in the cost of living and moderate rises in rents.

6. The movement of the real estate tax. The real estate tax which is by far the most important component of all of the operating expenses[34] deserves special attention. The tax (an ad valorem levy) is not based on income. This characteristic is reflected by the fact that the tax moved upward (Table 2-14) at an annual rate faster than that of operating income (Table 2-2) during each of the years, 1965, 1966,and 1967. (1966 is especially noteworthy since the tax increased by a very substantial rate of 9.4 per cent per annum, while operating income actually decreased by 1.1 per cent per annum.) In contrast to the acceleration in the annual rate of increase of the tax that took place during the early years (1965, 1966) we notice a definite decel-

TABLE 2-14

FHA SECTION 207 NYC SAMPLE--THE REAL ESTATE TAX: INDEX AND PERCENTAGE CHANGE OVER THE PRECEDING YEAR (1964=100)

Year	Index	Percentage Over the Preceding Year
1964	100.0	--
1965	105.5	5.5%
1966	115.4	9.4%
1967	124.6	8.0%
1968	129.0	3.5%
Average annual increase	--	6.6%
Population confidence limits for average annual increase:		
At 50% confidence probability		6.6-6.6
At 80% confidence probability		6.5-6.6

Source: FHA Section 207 NYC sample

eration in the later years (1967, 1968), so much so that by 1968 the rate of increase--3.5 per cent per annum--was well below that of operating income, 7.4 per cent per annum. The average annual increase in the tax during the complete period 1964-1968, approximately 6.6 per cent, exceeded materially the average annual increase in revenues, approximately 4.7 per cent (Table 2-1) as well as that of operating income, approximately 3.7 per cent (Table 2-2); it was obviously a substantial factor in the average annual increase of all operating expenses; 5.6-5.7 per cent (Table 2-1).

Placed in a historical context, a 6.5-6.6 per cent average annual increase looms rather large when compared to increases of the early decades of this century. (The two factors which are responsible for changes in the real estate tax burden,namely, (1) the tax rate and (2) real estate assessment, will be analyzed later in this chapter.) Average increases in real estate taxes for elevated apartment houses in New York City approximated 3.5 per cent per annum during the real estate boom days of the 1920's (Table 2-15), and for the following two decades either declined materially or stood still. A noticeable change took place, however, in the early 1950's: according to Winnick's sample of FHA Section 608 New York City elevator properties,[35] the index of real estate taxes moved from 62.3 in 1951 to 121.3 in 1955 (with 1952 as the base year), an average an-

TABLE 2-15

REAL ESTATE TAXES INDEX OF NEW YORK CITY ELEVATOR APARTMENT HOUSES (1947-1949=100)

Year	Index	Average Annual Percentage Increase/(Decrease)
Col. 1	Col. 2	Col. 3
1921	105	
1924	116	
1921-1924		3.4%
1925	118	
1929	136	
1925-1929		3.6%
1930	140	
1934	119	
1930-1934		(4.0)%
1935	121	
1939	119	
1935-1939		(0.4)%
1940	115	
1944	101	
1940-1944		(3.2)%
1945	96	
1949	99	
1945-1949		0.8%

Technical comment regarding Column 3: The average annual increase/(decrease) is that percentage change which, when applied to the index of the earliest year in each time period specified in Column 1, and compounded annually, will yield the index level of the latest year for that particular period per Column 2.

Sources: Columns 1 & 2: Grebler, Experience in Urban Real Estate op. cit., p. 232
Column 3: Computed from Column 2

nual increase of almost gigantic proportions, 18.1 per cent.[36] Measured by several other yardsticks the average annual increase of 6.5-6.6 per cent. would still appear very substantial indeed. It is more than twice the size of the average annual increase in the New York Consumer Price Index-All Items for the period 1964-1968, 2.9 per cent (Table 2-8). It is also of interest to note that real estate tax increases for New York City rental housing in the public sector were nowhere near the percentages cited here. An examination of the annual financial statements of the New York City Housing Authority reveals that during the period 1964-1968, payments in lieu of real estate taxes by City Program projects had a zero rate of change.[37] Similarly, a processing of Kristof's figures for the partially-exempt Mitchell-Lama properties, indicates a close-to-zero rate of change in real estate taxes for the period 1957-1967.[38]

Increases in the real estate tax result from either increases in the assessed value of properties (the latter consisting of land and improvements) and/or from the upward movement of the tax rate on real estate. There are several indications that increases in assessed valuations during the period under review had not been excessive. Assessments of both land and improvements of ordinary real estate in New York City, for the fiscal year 1964-1965, totalled $25,676,433,701;[39] four years later, in the fiscal year 1968-

1969, such assessments amounted to $28,523,172,555[40] -- an average annual increase of 2.7 per cent. The bulk of this increase, however, resulted either from new construction, or from additions to existing improvements,and therefore cannot be considered increases in assessment of the same unchanged parcel of real estate. An examination of the assessment records of each of the properties in our FHA Section 207 sample, was, therefore, undertaken.[41] It disclosed that assessments for those properties which underwent no further substantial improvement since 1964, totalled $140,185,000 in 1964-1965, as compared with $142,735,000 in 1968-1969--an average annual increase of a mere 0.5 per cent. At a real estate tax rate of 5 per cent per annum, such an increase in assessment will raise the annual tax bill on every $100,000 of previously assessed valuation by merely $25.00, or slightly above $2.00 per month. Our observation--it is worthwhile mentioning--is in the line with Sternlieb's comment that his non-controlled sample had less reassessment increases than almost all of the sampled rent-controlled properties,[42] a phenomenon attributed by him "to the adjustment of historically inadequate assessment levels on older structures in the City."[43]

The other factor causing increases in real estate tax expense, the upward movement of the real estate tax rate, registered noticeable advances during the period 1964-1968. Average annual increases in the tax rates for five boroughs

during the period under review have approximated 3.7 per cent (as indicated in Table 2-16). At a real estate tax rate originally equalling 5 per cent per annum, such an increase in the tax rate would raise the annual tax bill on every $100,000 of assessed valuation by a full $185.00 (or over $15.00 per month).

The special attention paid to the real estate tax trend is justified not only because of the heavy weight of this component in the total operating expenses structure, but also because it is probably the only component on which the government--restricted as it is, due to constitutional provisions and other limitations which will be pointed out below--has nevertheless a very direct influence, through the assessment process and the determination of the tax rate.[44] The government, though it also operates within obvious constraints (the City's needs on the one hand, and its limited revenue sources on the other)that impose a floor below which neither assessments nor real estate tax rates could decline, is nevertheless expected to carefully consider housing needs, etc., prior to the imposition of increased real estate taxes. Table 2-14, showing as it does a declining change in the percentage of increase in the tax expense during the years 1967 and 1968, suggests in fact that the New York City housing shortage, and the growing alarm over the decline in investment in residential rental housing, may have influenced the

TABLE 2-16

TAX RATE ON REAL ESTATE IN NEW YORK CITY 1964-65 TO 1968-69

Year	Tax Rate per $100				
	Manhattan	The Bronx	Brooklyn	Queens	Richmond
1964-65	4.52	4.56	4.53	4.56	4.53
1965-66	4.63	4.65	4.64	4.63	4.65
1966-67	4.994	5.022	5.013	4.999	4.993
1967-68	5.110	5.105	5.114	5.118	5.147
1968-69	5.244	5.243	5.268	5.248	5.249
Average annual increase 1964-65 to 1968-69	3.8%	3.6%	3.8%	3.6%	3.8%

Source: Information for the period 1964-65 through 1968-69 was provided by the Office of the Comptroller of the City of New York. Average annual increases were calculated from the 1964-65 and the 1968-69 rates.

public policy makers to avoid the imposition of much heavier real estate taxation which would tend to reduce even further the desirability of residential real estate investment. However, it should be emphasized that an annual average increase of 6.5-6.6 per cent for the period 1964-1968 (Table 2-14) is by no means negligible. It is in fact larger than the corresponding increase of 5.6-5.7 per cent for total operating expenses (Table 2-12), and it is of course higher than the increase in revenues of 4.7-4.8 per cent (Table 2-1). The question of future possible action in regard to the real estate tax in order to encourage investment in rental housing in New York City will be discussed in Chapter VI.

7. The movement of other operating expenses. Other operating expenses--mostly payroll to building service employees--rank next to the real estate tax in their degree of importance in the total structure of operating expenses. As indicated (Table 2-17) the average annual increase in this expense item during the period 1964-1968 was undoubtedly very modest, 1.7 per cent, well below several other major expense items, and less than the average annual increase of 2.9 per cent in the New York Consumer Price Index (Table 2-8). This minimal increase differes markedly from the actual wage raises gained by building service employees during the period under review. As shown (Table 2-18), minimum wage increases for apartment building

TABLE 2-17

FHA SECTION 207 NYC SAMPLE-INDEXES OF SELECTED OPERATING EXPENSES (1964=100)

Operating Expense	Index 1968	Average Annual Increase/ (Decrease)
Other operating (largely payroll)	106.8	1.7%
Repairs, Maintenance & replacements	170.4	14.3
Administrative	185.5	16.7
Fuel	103.8	0.9
Renting	29.8	(26.1)

Technical comment: As noted in Section A of this chapter, population confidence limits were calculated for the major items under analysis. Such limits were established in the present Section D for total operating expenses (Table 2-12) as well as for the real estate tax (Table 2-14) and -- as also noted in Section A -- they proved to be very narrow, prompting us to dispense with the time-consuming calculation of limits for the remaining operating expenses.

Source: FHA Section 207 NYC sample

TABLE 2-18

MINIMUM WAGE RATES FOR APARTMENT BUILDINGS (EXCLUDING SUPERINTENDENTS) 40-HOUR STANDARD WORK WEEK OF FIVE 8-HOUR DAYS

Classification of Employee	Weekly Wage Effective Period 4/21-4/20		Average Annual Increase
	1964-65	1968-69	?
Col. 1	Col. 2	Col. 3	Col. 4
Class A:			
Handyman	$ 83.37	$101.77	5.1%
Others	79.37	97.77	5.4
Class B:			
Handyman	81.06	99.46	5.2
Others	77.06	95.46	5.5
Class C:			
Handyman	78.75	97.15	5.4
Others	74.75	93.15	5.7

Sources: Columns 1, 2 & 3: 1964 and 1967 Apartment Building Agreements between Realty Advisory Board on Labor Relations (Incorporated) and Local 32B Building Service Employees International Union, AFL-CIO pp. 56 and 58 respectively.
Column 4: Computed from columns 2 and 3.

employees (excluding superintendents) averaged well over 5 per cent per annum, and this increase does not reflect the cost of additional fringe benefits. Sternlieb, who cites other sources, arrives at an even higher average annual increase for janitors, porters and cleaners for the period 1965-1968, 7.8 per cent.[45]

According to Grebler, an upward trend in wages paid to building employees had already been taking place in the 1920's; the subsequent decrease in wages during the depression years was mild compared to the fall in revenues and then, during the 1940's, despite the imposition of residential rent control in the City in 1943, wage expense doubled.[46] Grebler associates the upward trend of wages

> with the gradual elevation of building employees from one of the lowest paid categories of workers and with progressive unionization. These processes have involved a substantial reduction in hours of work and the introduction of 'fringe benefits' as well as sharp increases in wage rates. For some classes of workers, particularly in the lower-type buildings, minimum wage laws have also been important.[47]

Backman,[48] tabulating wages of building service employees during the war and the early post-war years (1940-1952), noticed that large increases in wages of superintendents, janitors, electricians, and plumbers were <u>not</u> accompanied by an equivalent increase in operating expenses of landlords for the apparent reason that <u>service had been reduced</u>: installation of self-service elevators, less frequent painting, etc. Grebler, on the other hand, was surprised to find

such substantial increases in wage expense during the 1940's , when services in residential buildings were supposed to be curtailed because of rent control, and he came to the conclusion that the long-term investors who supplied most of the data for his study were "more reluctant than other owners to cut down personal services."[49]

Our study lends support to Backman's observations and to the theory that building services will be reduced as a measure to preserve or improve profitability. Having witnessed an average annual increase in other operating costs of 1.7 per cent despite annual wage increases exceeding 5 per cent, we must conclude that the building services expense possesses a feature of flexibility that landlords resort to when more rigid expenses mount, and when market conditions allow such a step, namely, a growing housing shortage produces a "sellers' market" in which there is no longer a need to induce tenantry by the provision of excellent housing services. In this context, operating payroll expense may be considered a "selling" expense which varies in size in relation to the required selling effort.[50] It stands to reason, however, that the possibilities of curtailment of building services are not unlimited: a point may be reached beyond which any additional reduction in services may be a factor in housing deterioration, thus leading to reduction in revenues and to eventual capital losses.

8. The movement of repair and maintenance expenses.

Repairs, maintenance, and replacement, the third largest item of operating costs, rose very sharply during rhe period 1964-1968, 14.3 per cent per annum (Table 2-17). This major expense item is also largely within the discretion of the landlord,[51] and yet we witness in this case, contrary to the behavior of the other operating expenses (largely payroll of building service employees), an upward trend of major proportions. This phenomenon is also in marked contrast to the behavior of repairs and maintenance costs in the rent-controlled sector as established by Sternlieb who found "indication that landlords have taken the option of simply reducing the actual physical level of the repairs and mintenance through maintaining the dollar figure."[52] Therefore, we may conclude that the landlord's different behavior in the case of maintenance of controlled properties versus non-controlled ones has a rationale of its own: maintenance expenses may indeed be curtailed in controlled apartment buildings because of the "earning squeeze," the need to economize due to difficulties in obtaining rent increases,[53] and the limited expectations (due to rent controls) of capital gains on such properties. In the non-rent-controlled sector, however, different considerations apply: the landlord may indeed feel the inflationary pressure of rising costs to which he may choose to react by some curtailment of services; the increased rent route is

also much more freely available to him than to the owner of a controlled building, but he would apparently hesitate to economize falsely be reducing repairs and maintenance expenditures, since such a course of action might trigger deterioration in the general conditions of his property, drastically eliminating what otherwise may have been excellent prospects for capital gains. Profit expectations through capital appreciation, which in turn is due largely to a growing market demand, have traditionally motivated investors in non-controlled rental housing. That levels of rents and property returns of New York City FHA Section 207 properties are subject mainly to the influence of such market demand, similar to other non-controlled properties, has been demonstrated earlier in this chapter and will be further demonstrated in Chapter V. The behavior of repairs and maintenance expenditures as shown here further confirms the important role played by capital gains expectations.

Several authorities have referred to the repairs and maintenance expense, as well as to the service expense, as "strictly a selling expense,"[54] which will be mercilessly reduced in a sellers' market where a state of an almost nil vacancy exists. Others have pointed out to the discouraging effect that the present income tax laws exercise over repairs, maintenance and replacement expenditures in certain rental properties.[55] Our findings require modifi-

cations of such statements: repairs and maintenance may possess some characteristics of selling expenses, but this probably holds truer in the case of controlled properties; where non-controlled apartment buildings are involved, owners' expectations of future capital gains play a most important role, thus diminishing the likelihood of reduced repairs and maintenance expenditures due to a decline in vacancies. And as to the possible negative effect of the tax laws on repairs and maintenance, (the IRS requirement of capitalization of such expenditures in too many cases, thus allowing only slow write-offs for income tax purposes), this too will be mostly felt once owners' expectations of capital gains have been dimmed due to the age of the property or the general decline of property values in a deteriorating neighborhood.

9. The movement of the remaining operating expenses. Since the remaining operating expenses combined, account for less than 25 per cent of the expense dollar, they are not as significant as the items discussed above; their trend, however, is indicative of the way certain market forces influence housing operating costs. It will be noted that administrative costs (mostly management charges) registered the largest average annual increase during the period under review, 16.7 per cent. Such a high increase cannot be explained solely by the rise in the office clerical wage index, which--as pointed out by Sternlieb--recorded an

average annual increase during the period 1965-1968 of 4.3 per cent.[56] It will also be noted that gross rent increased by an average annual rate of merely 2.8 per cent (Table 2-5). It becomes apparent therefore, that management charges rose much faster than rents, thus consuming more of the rent dollar at the end of the period than they did at the beginning. To the extent that such management fees are actually earned by the landlord, either directly or indirectly (the latter through related parties), their rise signifies increased income to ownership, and not a genuine increase in operating expenses.

The modest increase in <u>fuel expense</u>, 0.9 per cent per annum, falls noticeably short of Sternlieb's computed annual average for the period 1965-1968 of 3.1 per cent.[57] We may therefore reach a conclusion similar to the one arrived at in regard to other operating expenses (i.,e. payroll), namely; a decline in fuel consumption of non-rent-controlled apartment buildings must have taken place during the period 1964-1968.[58] Economizing in fuel consumption helps to limit total increases in operating expense, thus improving profitability of the affected properties: a housing shortage growing in severity, limits tenants' options of reaction to such a cut in services. It should nevertheless be realized that, as in the case of other operating expenses, opportunities for reduction in fuel services are not endless, and once the minimal required level has been reached, the possibility of further savings through drastic reductions in

fuel consumption has been eliminated.

The rapid decline in renting expense during the period 1964-1968, 26.1 per cent per annum, is a predictable consequence of the very sizable decline in vacancy losses for the same period, approximately 31.5 per cent per annum (Table 2-5). Renting expense is clearly a selling expense which will be easily eliminated in a situation of a growing housing shortage, since the search for tenants--the essence of renting expense--turns then into a search by tenants for residential accommodations.[59]

10. Cross-sectional analysis. A cross-sectional tabulation of the trend of operating expenses (Table 2-19) discloses that the real estate tax--the largest single operating expense--rose most in Manhattan, approximately 10.5 per cent per annum, thus reflecting the unparallelled increase in Manhattan's gross rents and the decrease in Manhattan's vacancies (Table 2-11). To this extent, the real estate tax--though being an ad valorem levy--assumes characteristics which resemble that of an income tax. We find in fact that the real estate tax helped to equalize the rate of growth of operating income of Manhattan properties with that of highrisers in the other boroughs, approximately 4.0 per cent per annum (Table 2-4). Interestingly, in analyzing boroughs other than Manhattan, the evidence is that the tax on six-story buildings grew more rapidly (5.8-5.9 per cent per annum) than the tax on highrisers

TABLE 2-19

FHA SECTION 207 NYC SAMPLE-ACROSS-SECTIONAL TABULATION OF SELECTED OPERATING EXPENSES INDEXES (1964=100) AND AVERAGE ANNUAL INCREASES

	Manhattan	Other Boroughs		Total
	All Highrisers	Highrisers	Six-Stories	All Boroughs, Six-Stories & Highrisers
Real estate tax index for 1968	149.1	115.9	125.6	129.0
Average annual increase in the real estate tax	10.5%	3.8%	5.9%	6.6%
Population confidence limits for average annual increase:				
At 50% confidence probability.....	10.5-10.5	3.7-3.8	5.8-5.9	6.6-6.6
At 80% confidence probability.....	10.4-10.6	3.7-3.8	5.8-5.9	6.5-6.6
Other operating expenses (largely payroll) index for 1968	88.3	117.2	216.2	106.8
Average annual increase/(decrease) in other operating expenses.....	(3.1)%	4.0%	21.3%	1.7%

TABLE 2-19
(cont'd)

	Manhattan	Other Boroughs		Total
	All Highrisers	Highrisers	Six Stories	All Boroughs, Six Stories & Highrisers
Repairs, maintenance and replacement index for 1968	240.6	135.3	141.6	170.4
Average annual increase in repairs, maintenance and replacement expenses	24.5%	7.9%	9.1%	14.3%
Administrative expenses index for 1968	155.7	345.3	147.7	185.5
Average annual increase in administrative expenses	11.7%	36.3%	10.2%	16.7%
Renting expenses index for 1968	20.3	20.7	48.4	29.8
Average annual (decrease) in renting expenses	(32.9)%	(32.5)%	(16.6)%	(26.1)%

Source: FHA Section 207 NYC sample

(3.7-3.8 per cent per annum). The impact of this differential has been to slow the average annual increase in operating income of six-story apartment houses considerably, approximately 1.7 per cent (Table 2-4) as compared with approximately 4.0 per cent for highrisers in the other boroughs.

An analysis of other operating expenses shows that owners of Manhattan sample properties took full advantage of the growing housing shortage, cutting such service expenses--which as noted earlier are similar in nature to selling expenses--by 3.1 per cent per annum. Owners of six-story sample properties in other boroughs, on the other hand, continued to bid aggressively for tenants despite the housing shortage, increasing other operating expenses by 21.3 per cent per annum, a rate that by far exceeds any inflationary increases in operating costs, thus indicating a real, rather than a strictly monetary, upward movement of the level of services. Owners of sample highrisers in the other boroughs incurred a moderate average annual increase in other operating expenses, 4.0 per cent, a rate which indicates a slight reduction in real servides during the years 1964-1968, since it falls below monetary increases in wages of service personnel for the same period.

Further analysis of the trends of individual operating expense items suggests that owners' expectations in regard to highrisers in other boroughs narrowed during the period

under review. We thus witness a remarkably high average annual increase in repairs, maintenance and replacement expenses for Manhattan sample properties: 24.5 per cent, an indication of belief in the future prospects of such real estate and an understandable desire to preserve the quality and value of these buildings. The picture changes in the other boroughs, where the corresponding rate is 9.1 per cent per annum for six-story apartment houses, and a still lower rate for highrisers, 7.9 per cent per annum. The impression of dimming owners' expectations in regard to highrisers in boroughs other than Manhattan is further strengthened by the unusually high average annual increase in administrative expenses for such highrisers, 36.3 per cent, well above the corresponding rates for Manhattan properties, 11.7 per cent per annum, and also above the rate of the six-story buildings in the other boroughs, 10.2 per cent per annum. This high rate of increase for the highrisers in the other boroughs suggests diversion of funds to proprietary interests through enlarged management fees, thus increasing the actual return on investment to these interests. The decrease in renting expenses was universal though much less pronounced for six-story apartment houses in boroughs other than Manhattan,. This observation is understandable in view of the growing housing shortage in New York City; it nevertheless suggests once again, that owners of six-story properties continued to bid

for tenants somewhat more aggressively than did landlords of highrisers.

NOTES TO CHAPTER II

[1]Chain indexes permit the linking of different years' data despite the fact that the number of sample members may vary from one year to the next, as is the case with our sample (due to construction of properties in different years). The following comments by Grebler explain the use of these indexes:

> "A common technique for index construction in statistical series with a varying number of items is, first, to select the group of cases for which data in a given year and the previous year are available. The group total for the given year is then related to the group total for the previous year, and a ratio is established which is known as a 'relative'. The relatives are linked together by successive multiplication, year by year, and the resultant series is adjusted in such manner that the indexes for the base period equal 100... Basically, then link relatives express the percentage change from year to year after taking account of the effects of differences in coverage from year to year. For convenience, the indexes so constructed are referred to as chain indexes."

See Grebler, Experience in Urban Real Estate Investment, pp.45-46.

[2]The use of confidence probability levels has been explained in note 45 (Chapter I). The limits established in the present chapter were derived by comparing the 1964 and the 1968 data for those properties which appeared in the sample in both years. As stated in the preceding note, however, chain indexes employ data for identical properties in any two immediately consecutive years, so that the 1968 properties employed for index purposes were those appearing also in 1967 and not necessarily in 1964. This slight discrepency in the precise constitution of the sample for confidence limits purposes is not deemed to have any material effect on the resulting limits thus established. The confidence limits were actually calculated for the index levels in 1964 and 1968 respectively, thus providing--for each year--an interval between the index high and low points. These intervals were, however, presented in this chapter in terms of the minimum and maximum average annual percentage increase (or decrease) that would account for the change in index levels between 1964 and 1968.

[3]One should not be puzzled by the growth in operating income during the period 1964-1968, despite the fact that operating expenses increased at a faster average annual rate than revenues, for the simple reason that operating expenses are obviously smaller in absolute dollar size than revenues, constituting--as will be shown in Chapter III--somewhat over 50 per cent of the latter. A simple example will suffice: if revenue is 10 and operating expenses are 6, operating income is of course 4. Assume a growth in revenue of 40 per cent or 4, and a somewhat bigger percentage increase in operating expenses, say 50 per cent, or 3. The new figures are thus: revenue 14 less operating expenses of 9, yielding operating income of 5, which is bigger than the previous operating income of 4. Operating expenses increasing faster than revenues, have thus, nevertheless allowed for an increase in operating income.

[4]To the extent that vacancy & loss figures include--in addition to losses on unrented space--concessions granted voluntarily to tenants to induce renting in times of excess housing supply, as well as bad debts sustained through occasional failure of tenants to pay rents, a phenomenon which tends to occur more often during periods of housing abundance when tenants' fear of eviction is minimal, then these figures include an element of discount on rents (rent reduction) and their gradual elimination means an effective addition to rent over and above the increases indicated by the gross rents trend.

[5]This upward movement of gross rent at an accelerated rate was common to the whole non-rent-controlled housing sector, and resulted in a widely spread tenant complaint about "rent gouging" in 1968. An analysis of the complaints, which were instrumental in the enactment of the Rent Stabilization Law of 1969, is provided in Report to the Mayor on an Investigation into Rental Increases in the Non-Controlled Housing Market (New York: Housing and Development Administration and Department of Consumer Affairs, 1969). The following comment by Rand, which sums up rent developments during the 1960's, suggests that the increases have further accelerated by 1969:

> "In the uncontrolled sector of the market, landlords have generally been able to increase rents to cover rising costs and protect their yields, except during the building boom of the early 1960's, when high vacancy rates in newly constructed buildings forced them to set rents below full costs in many cases. A number of these buildings fell behind in their mortgage payments. As the market

> has tightened and leases have expired, they have attempted to recoup these losses and cover subsequent cost increases. In 1968-69, rent increases of 25 per cent on two-year leases were not uncommon."

See Lowry (ed.), op cit., pp.6-7.
Niebanck sounds a similar note: "since the [April] 1968 survey was taken, rents in the never controlled section have risen sharply albeit selectively."
See Niebanck, op. cit., p. 47.

[6]The periodical New York City Vacancy surveys by the United States Bureau of the Census provide parallel evidence of the ever-sharpening housing shortage in the second half of the 1960's. The December 1962 survey showed a rental vacancy rate which was 1.8 per cent (virtually identical to the 1960 level). By early 1965 there was a noticeable easing of the housing shortage, and the rate stood at 3.2 per cent. As of April 1968, however, the vacancy rate dropped to what appears to be an all-time low, 1.23 per cent. See Kristof, People Housing and Rent Control in New York City, p.9; Rapkin, The Private Rental Housing Market in New York City 1965, p.8; Niebanck, op. cit., p. XXXIX, respectively.

[7]Sherman J. Maisel, "Have We Underestimated Increases in Rents and Shelter Expenditures?" The Journal of Political Economy, LVII, (April 1949); Winnick, American Housing and its Use, pp. 112-116; Margaret G. Reid, Housing and Income, (Chicago: University of Chicago Press, 1962), p.227.

[8]This comparative analysis applies to the privately financed housing sector (fully expaying)only, whether rent-controlled or non-rent-controlled. The public housing and publicly assisted private housing sector benefits from governmental aids that forbid a comparison with those segments of the housing market which are expected to operate self-sufficiently. It will be noted however, that rent increases occurred in the public sector as well: an examination of the annual fiscal reports of the New York City Housing Authority will reveal anaverage annual increase in rents of projects under the City Program of approximately 1.6 per cent for the perios 1964-1968. According to a recent press report the "Authority's last general rent increase in 1959 averaged nine per cent, with costs reported almost doubling since then." Therefore, "Chairman Simeon Golar said that even a 15 per cent increase would barely cover our rent operating deficit." But he also said that the actual decision would depend on the outcome of pending wage negotiations, probably adding to the defi-

cit, and possible Federal aid." See "Rent Rise is Seen in Public Housing," New York Times, February 1, 1971, p. 37.

Using Kristof's figures on City-financed Mitchell-Lama housing for the period 1957-1967, one arrives at an average annual rent increase of approximately 3 per cent, but the average for the mid-1960's alone may vary from this figure. See Kristof, "Occasional Memorandum No. 19: Rising Rents and Housing Costs in the City-Financed Limited Profit Housing Companies Program: 1957-1967," p.11.

[9]Niebanck, op. cit., p. 46.

[10]However, Niebanck alludes in a footnote to changes that occurred in the later part of 1968. Ibid., p.47.

[11]There is ample proof that a heavy legacy of high vacancies burdened not only FHA Section 207 properties, but the total non-controlled housing sector in New York City during the early 1960's. It is also evident that these vacancies declined dramatically by 1968. The tale unfolds through the following schedule:

New York City Vacancy Rates

Rental Housing Sector	1965	1968
Total	3.19	1.23
Controlled	1.98	1.05
Decontrolled	5.88	2.06
Never Controlled	4.37	0.73
SRO-type (Single Room Occupancy)	11.01	6.34
Public	0.34	0.09

Source: United States Bureau of the Census, New York City Housing and Vacancy Survey, 1965 and 1968. Cited by Niebanck, op. cit., p. 219.

It will be noticed that in 1965 the never controlled sector was marked by a vacancy rate of 4.37 per cent, well above the 3.19 per cent rate ofor the total rental housing secoor. However, by 1968 the vacancy rate for the former stood at 0.73 per cent. Having been reduced to a mere sixth of its 1965 size, it was now significantly below the total rental housing sector vacancy rate of 1.23 per cent; the latter having declined by less than 50 per cent in relation to its 1965 level.

An unmistakable confirmation of the above trend is provided through an examination of the apartment rental advertisements in the New York Times. A count of the number of advertisement columns in four different editions of the Times, three months apart from each other, during each of the five years, 1964-1968, shows that for such typical non-controlled sections of town as Riverdale, parts of Queens and the East Side of Manhattan (mid-town and uptown), the number of columns declined by 1968 to approximately a third of the 1964 volume.

[12]Grebler, Experience In Urban Real Estate Investment, p. 47.

[13]Winnick, Rental Housing: Opportunities for Private Investment, p. 284.

[14]Wendt and Wong, op. cit., p. 637.

[15]James, in his study of walk-up apartment buildings in a mid-western city has noted "abnormal" rent increases during the years 1953-1955, which he attributed to realtors' attempts at "catching up" with the rest of the economy. See James, op. cit.

[16]Realtors have made it clear that there are no ceilings on incomes of Section 207 tenants. Furthermore, the point has been advanced by realtors that since rent levels in "207's" bear close relationship to those of other non-controlled dwellings similarly situated, the "207" occupants do--in all probability--earn incomes that enable them to enjoy the standard of living prevailing in the particular community. See note 51 to Chapter I.

[17]Niebanck, op. cit. pp.93-94.

[18]For a discussion in depth of trends in relation of housing consumption to income of American households see Grebler, Blank and Winnick, Capital Formation in Residential Real Estate, pp. 124-133. Based on a study of a 60 sixty-year period, 1890-1950, the authors suggest that there "is impressive evidence that" with growing affluence "housing has moved downward in the consumer's scale of preferences. Newer consumer goods and services have been more successful in the competition for a place in family budgets...The relative decline in the demand for housing appears to have been even more severe than for other groups of 'indispensible' commodities." Ibid., p. 131. Reid, on the other hand, concluded that the American consumer regards housing as luxury, rather than a necessity, tending, therefore, to increase housing expenditures at an even faster rate than the rate of increase in his normal income. Reid, op.cit.

[19]Derived from 1965 and 1968 census data. See Series I, Table 36, Gross Rent-Income Ratio, United States Bureau of the Census, New York City Housing and Vacancy Survey, 1965 and 1968 respectively.

[20]Mayor Lindsay, in testimony on July 25, 1969, before the Subcommittee on Housing and Urban Affairs of the Senate Banking and Currency Committee, complained of "outdated federal subsidies" for public housing projects, since these subsidies "aren not permitted to reflect increase in operating costs." See press release by the Office of the Mayor, (New York: July 25, 1969), p. 3. (Mimeographed). According to a newspaper account, some 45,000 housing units in Mitchell-Lama middle-income developments were granted a maximum 80 per cent real estate tax exemption "to relieve the financial pinch caused by rising interest costs and increased operating expenses." See "45,000 Mid-Income Housing Units Get 80% City Tax Exemption," New York Times, October 10, 1969, p. 1.

[21]Lowry, op cit., p. 6. The Rand figure is based on an analysis of the records of 57 Federal public housing projects. The report mentions the lack of a comparable time series for private rental housing,but it speculates that the latter is subject to much the same inflationary pressures, etc., as are public units. The present study, which provides the desired time series for certain private rental housing for the period 1964-1968, confirms Rand's speculations.

[22]The Mayor's Rent Control Committee, op. cit., p. 27.

[23]Sternlieb, Urban Housing Dilemma.

[24]Ibid., p. 318.

[25]Ibid., p. 319.

[26]Sternlieb has similarly concluded--in the case of repairs expense--that so-called "elective" expenses (those given to the control of the landlord) tend to be higher in the non-controlled buildings. Ibid., p. 374.

[27]The operating expenses trend at that time (in the 1930's) closely paralleled changes in the Consumer Price Index which during the years 1930-1934 dropped significantly in New York, from 59.8 to 49.2 (1957-59 is the base year), and then during the period 1935-1939 remained virtually unchanged, slowly moving from 49.7 to 49.9.

[28]Wendt and Wong, op. cit., p. 637.

[29]This increase is identical to the one established by them for gross rent for the same period. Ibid.

[30]Additional studies have demonstrated the high rate of annual increases in operating expenses during the post-war period: Winnick, who studied 18 Chicago apartment properties, found a move in operating expenses from 80.8 in 1946 to 104.1 in 1950 (1947-1949 base), an average change of 6.5 per cent per annum, while in the 1950's there was a further upward move from 106.3 in 1951 to 147.7 in 1956, an average increase of 6.7 per cent per annum. See Winnick, Opportunities for Private Investment, p. 267.

According to James' study of 6 properties in a mid-western city, expenses increased from 88.5 in 1946 to 102.9 in 1959 (1947-1949 base; the shift of index from a 1939 base was done by Winnick, Ibid., p. 268), an average annual increase of 3.8 per cent; the increase in the next half decade, according to James, was dramatic--from 101.5 in 1951 to 145.6 in 1955, an average annual increase of 9.4 per cent. It should be noted, however, that certain studies have established what appear to be isolated cases of much more modest increases in operating expenses, even during the post-war period: Winnick computed the index of operating costs of FHA Section 608 elevator apartment houses in New York City (the number of projects ranged from 9 to 44 during the period under review) to be 101.3 in 1951 (1952 is the base) and 109.6 in 1955, an average annual increase of 2.0 per cent. Ibid., p. 284.

Using Kristof's figures on City-financed Mitchell-Lama housing for the period 1957-1967, one arrives at an average annual increase in maintenance and operating costs of approximately 2.2 per cent; but a word of caution is in place, real estate taxes,which are a very substantial part of operating costs of private rental properties, are excluded from the above Mitchell-Lama costs. It should also be kept in mind that Kristof's figures cover the decade 1957-1967, while the applicable rate for the mid-1960's alone may be somewhat different. See Kristof, "Rising Rents and Housing Costs in City-Financed Limited Profit Housing."

[31]Federal Housing Administration, A Survey of Apartment Dwelling Operating Experience in Large American Cities,p.I31.

[32]Grebler, Urban Real Estate Investment, pp.47,49.

[33]According to Grebler's data for New York City elevator apartment houses (presented in Tables 2-7 and 2-13 of this study), an average annual decrease in gross income of 10.2 per cent during the depression years 1930-1934, was accompanied by an average annual decrease in expenses of

2.8 per cent. In the case of New York City walk-up apartment houses, however, during the same period as shown by Grebler (Ibid., p. 233), gross income dropped from 115 to 68, an average annual rate of 12.3 per cent--more than the 10.2 per cent rate for elevator properties--while on the other hand, total expenses declined from 74 to 72, an average annual rate of a mere 0.7 per cent, as compared with the 2.8 per cent rate for the more luxurious elevator dwellings. When real estate taxes are excluded, other operating expenses of walk-up apartment houses in fact registered an increase of 1.2 per cent per annum, during the period 1930-1934, a clear sign of inflexibility of expenses. Other expenses of elevator buildings during those years recorded an average annual decrease of 2.3 per cent.

[34]It weighs only a little less than all other operating expenses combined. See Chapter III.

[35]Winnick, Opportunites for Private Investment, p. 284.

[36]The magnitude of such an increase is observed all the more when a comparison is made with the figures of Wendt and Wong for a sample of FHA Section 608 San Francisco properties, where the property taxes index moved from 100 in 1952 to 125 in 1957; an average annual increase of 4.6 per cent; the rate of increase during the subsequent half decade, 1957-1962, though more than doubling-- 9.9 per cent per annum (thus having moved the index by 1962 to 200)--was nevertheless well below the 18.1 per cent rate of Winnick's New York City properties. See Wendt and Wong, op. cit., p. 637.

[37]N.Y.C. Housing Authority, Annual Fiscal Report, (1965-1969), exhibit B of each annual report.

[38]Kristof, "Rising Rents and Housing Costs in the City-Financed Limited Profit Housing Companies."

[39]According to information provided in writing by the Office of the Comptroller of the City of New York.

[40]Ibid.

[41]The Annual Record of Assessed Valuations Indicated by Parcel Numbers is located in Borough Hall of each of the five boroughs of New York City. The Record was examined for fiscal years 7/1/1964-6/30/1965 and 7/1/1968-6/30/1969.

[42]Sternlieb, Urban Housing Dilemma, p. 213.

[43]Ibid. Further processing of Sternlieb's figures (p. 211) yields an average annual increase in assessments of non-controlled buildings of 1.7 per cent during the period 1960-1967. On the other hand, the set of controlled properties that most resembled the non-controlled properties, namely, structures built after 1929 containing 50 units or more, registered a higher increase in assessments during the same period, 2.6 per cent per annum.

[44]The New York City real estate tax rate is determined by deducting the estimated General Fund revenues and the estimated supplementary revenues from the total expense budget appropriations. The balance thus arrived at is then divided by the current assessed valuation. See New York City, Comptroller, Annual Report, fiscal year 1968-1969, p.8.

[45]Sternlieb, Urban Housing Dilemma, p. 436. Computation of average was based on data appearing in U.S. Department of Labor, Bureau of Labor Statistics, Area Wage Survey, New York, Five Boroughs, Bulletins: 1430-80, 1465-82, 1530-83, 1575-78, 1625-88.

[46]Grebler, Urban Real Estate Investment, p. 82.

[47]Ibid., p. 87.

[48]Backman, op. cit., p. 64.

[49]Grebler, Urban Real Estate Investment.

[50]Winnick refers to "maintenance and services" as "selling costs" that "tend to decline where no great sales effort is required to achieve full occupancy." Winnick, Opportunities for Private Investment, p. 138.
For our observations regarding repairs and maintenance, see following section of text.

[51]The bulk of this item consists of expenditures on repairs and maintenance. The replacement portion of the item, which is secondary in importance, is determined by FHA regulatory requirements. Our analysis indicates however, that the increases occurred in the former component which is the large and the discretionary one, rather than in the relatively minor and obligatory replacement expenditures.

[52]Sternlieb, Urban Housing Dilemma, p. 319.

[53]Grebler, in observing repair expenditures from 1940 to 1950, comments that "it is reasonable to infer that owners,

caught in the pinch between controlled rents and rising expenses, tended to economize on upkeep, repair, replacement and modernization." He claims that such is the "consequence of rent control observed in much more aggravated form in European countries with prolonged control of rents." See Grebler, Urban Real Estate Investment, p. 88. This writer has personally witnessed the exterior appearance of rental properties abroad, in choice urban locations, which were subjected to rigid rent controls for an extended period of time, and he therefore tends to concur with Grebler's observation.

[54]James, op. cit. See also Winnick, note 50 above.

[55]According to the Douglas Commision, the tax laws tend "to reinforce underlying conditions that now inhibit sound maintenance and rehabilitation of old rental housing, especially in deteriorating city neighborhoods." National Commission on Urban Problems, Building the American City., p. 406.

[56]Sternlieb, Urban Housing Dilemma, p. 443. Computation of average was based on data appearing in U.S. Department of Labor, Bureau of Labor Statistics, Area Wage Survey, New York, North East, and New Jersey, Bulletins, 1430-80, 1465-82, 1530-83, 1575-78, 1625-88.

[57]Sternlieb, Urban Housing Dilemma, p. 435. Computation of average was based on data appearing in U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index, U.S. City Average and Selected Areas.

[58]It should be noted that such a conclusion regarding reduction in fuel services is suggested in light of Sternlieb's figures mentioned above, as well as the fact that our analysis has extended over five years, a period sufficiently long to indicate a trend. No such conclusion would be justified by an analysis of a much shorter period, say two years, in which case fuel expenditures may fluctuate from one year to the next, due to random weather conditions (a severe winter in year one vs. a mild season in year two, etc.).

[59]An early FHA study stated that "renting and administrative expense tended to increase during the depression years because of the increasing cost of bad debts and tenants' concessions." In light of our analysis, the question may now be posed in retrospect whether the increase in renting expense during the 1930's would have been as large as it was, had the depression of those years been accompanied by a severe housing shortage rather than ample housing resulting from the construction boom of the 1920's. See Federal Housing Administration, A Survey of Apartment Dwelling Operating Experience in Large American Cities, p.131.

CHAPTER III

OPERATING RATIOS

A. Significance of Operating Ratios

Operating expenses, as well as any likely residual of operating income, are provided for by the revenue dollar, and it is well accepted analytical technique to express the former as a percentage of the latter.[1] The use of operating ratios has become crucial to public policy makers who, when called upon to provide ceilings on permissible rent increases for a given period, would apply projected rises in various operating expenses to a weighted index of expenses in order to determine the overall expense increase that should be compensated for by an equitable rise in rents.[2]

Operating ratio analysis has proven no less valuable for real estate investment decision purposes. The value of an income-producing property such as an apartment building depends on the expected flow of operating income to be generated by it, and only upon determination of the operating expense ratio can one apply its complement--the operating income ratio--to the expected revenues, thus arriving at the expected operating income figure. A deterioration in the operating income ratio (equivalent to an increase in the operating expense ratio) combined with a given level of rents and a required rate of return by investors will reduce the

value of the property; an improvement in the operating income ratio--on the other hand--will have the opposite effect, thus causing a capital gain to the owner of the income-producing property.[3]

The "rent multiplier", a commonly used device for appraisal of apartment buildings--expressing the market value of the property as a multiple of its annual rentals--is similarly dependent on the property's operating ratios: the higher the operating expense ratio the lower the multiple sustained by a given level of rent revenues and the lower the value of the property.[4]

B. 1968 Operating Ratios

An analysis of our FHA Section 207 New York City sample for 1968 shows that on the average operating expenses consumed approximately 55 cents of the revenue dollar leaving 45 cents for operating income (Table 3-1). In other words, less than half of the revenue dollar was available for debt servicing (amortization of mortgage principal and interest payments), depreciation, and profit to equity interests.

1. Comparison with 1964 ratios. A comparison of the 1968 ratios with those of 1964 (Table 3-2) provides us with a reasonable confirmation of our earlier finding (Chapter II) that during the period 1964-1968 revenues have increased at a slower rate than operating expenses; as a result less of the revenue dollar was available on the average for operating income at the end of the five-year period (around 45 cents

TABLE 3-1

FHA SECTION 207 NEW YORK CITY SAMPLE--MAJOR OPERATING RATIOS, 1968

Average and Confidence Limits	Percent of Total Revenues	
	Total Operating Expenses	Operating Income
Arithmetic mean of sample----------	55.5%	44.5%
Confidence limits for population mean:		
At 50% confidence probability.....	55.0-56.0	44.0-45.0
At 80% confidence probability.....	54.5-56.5	43.5-45.5

Source: FHA Section 207 New York City sample

TABLE 3-2

FHA SECTION 207 NEW YORK CITY SAMPLE-MAJOR OPERATING RATIOS, 1964

Average and Confidence Limits	Percent of Total Revenues	
	Total Operating Expenses	-- Operating Income
Arithmetic mean of sample----------	53.5%	46.5%
Confidence limits for the population mean:		
At 50% confidence probability.....	52.9-54.1	45.9-47.1
At 80% confidence probability.....	52.3-54.7	45.3-47.7

Source: FHA Section 207 New York City sample

TABLE 3-3

PRINCIPAL OPERATING RATIOS FOR NEW YORK CITY ELEVATOR APARTMENT HOUSES

(Five - year averages)

Period	Percent of Gross Income	
	Operating Income	Total Expenses
1920-1924	48	52
1925-1929	55	46
1930-1934	43	58
1935-1939	32	68
1940-1944	27	73
1945-1949	31	69
1950	27	73

Source: Grebler, Experience In Urban Real Estate Investment, ibid., p. 255.

than at the beginning of the period (around 46 cents). This deterioration in operating income as a percentage of total revenue means that a fixed level of rentals could support less of debt servicing and income to equity interests in 1968 than it did in 1964. Putting it in terms of the rent multiplier, such a development means that a given level of rentals resulted in a lower multiplier in 1968 than it did in 1964,[5] or that under conditions of no change in rentals, market values would have declined from 1964 to 1968. The implication of this development to prudent investors, be they prospective mortgagees, or holders of equity interests, can be stated as follows: a fixed level of rentals would have induced a lower amount of investment in 1968 than it would have done in 1964. However, a more comprehensive evaluation of the desirability of such investments will be possible only after consideration of investment returns during the period 1964-1968 (Chapter V).

2. Comparison with other New York City properties.

How do these findings compare with other recently computed operating ratios for multi-family buildings? The Sternlieb Report[6] allows a comparison with ratios applicable to other wide sections of the present New York City rental housing market. (It should be noted though, that Sternlieb's figures are as of 1967, rather than 1968; but the year-to-year variation could not be that large.) As expected, Sternlieb established a higher ratio of operating expenses, and consequently a lower profitability (measured as operating income ratio) among rent-controlled properties: the mean

contribution to debt, depreciation, and profit as a percentage of net rent received for the controlled sample was 35.7 per cent and for the non-controlled sample it was 45.4 per cent.[7] The corresponding 1968 FHA mean of 44.5 per cent (Table 3-1) comes very close to the latter 1967 figure (45.4 per cent is actually within the FHA Section 207 range for the population mean at 80 per cent confidence level.) The substantial difference between these figures and figures for the controlled properties, serves to draw attention to the handicaps that are associated with the operation of properties that are subject to rent control on one hand and to increased operating costs due to a combination of factors such as inflationary pressures, aging, etc., on the other hand; a typical "squeeze" on income, indeed.[8] Non-controlled properties, however, such as the FHA Section 207 units as well as other apartment buildings, due to their relative young age in comparison to controlled properties, may be burdened by a high debt servicing requirement so that the remaining cash flow available to the equity owner after mortgage amortization and interest payments may not necessarily be that high vis-a-vis the flow generated by successful rent-controlled apartment houses.[9] This possible differential in debt servicing may thus help to "smooth" large differences in returns to equity interests that would otherwise result from the varying operating income ratios discussed above.

Both the Sternlieb report and our findings demonstrate

that the National Commission on Urban Problems has somewhat understated--as far as New York City is concerned--the share of operating costs in the total "revenue pie", when it recently stated that these costs "today account for about one-half the rental charge on multi-family homes."[10] A minimum 55 per cent average ratio of operating expenses to total revenue was the case in 1968 in New York City.[11]

3. Comparison with properties outside New York City. The New York City ratios of operating expenses are--from several indications--among the high ones in the United States and Canada: according to one source[12] which provides data for 25 large North American cities, some 13 cities had lower operating expenses ratios for unfurnished elevator buildings in 1968. It should also be noted that a somewhat earlier study of FHA Section 608 apartment properties in the San Francisco Bay Area[13] had arrived at a lower operating ratio of expense to gross rent of 47.3 per cent. This observation must lead to the conclusion that at a given level of rentals and a given level of required investment in housing, New York City will be at a definite disadvantage in comparison to numerous other North American cities; or to put it differently: to induce investors to a given investment in housing, New York City apartment houses will have to offer a higher revenue than that provided by similar properties in several other American cities.

4. Comparison with ratios in the past. How do the present ratios compare with those of years past? Grebler,

Blank and Winnick[14] mention a "long-run decline in the gross rent multiplier" which "appears to be associated with a long-run decline in the ratio of net to gross income."[15] Their observation is coupled, however, with a qualifying comment regarding the limitations of the avialable data. In addition to several others, the present study allows a closer examination of the question.

Grebler,who studied certain available data in New York City for the first half of this century, has indeed observed a "marked deterioration"[16] in the ratio of net-to-gross income during the 1930's and the 1940's (Table 3-3). It will be noticed that the share of operating income in gross income has been more than halved during a 25-year period, decreasing from a high of 55 per cent in the real estate boom days of 1925-1929 to a low of 27 per cent in the aftermath of World War II and the start of hostilities in Korea in 1950. The share of operating expenses in gross income--the complement of the net income ratio--has correspondingly increased during the said period from a low of 46 per cent to a high of 73 per cent.

A decline in the ratio of net operating income to gross income has also been indicated by a more limited FHA study covering the decade 1926-1935.[17] It shows that while in 1926 operating expenses of New York apartment projects under examination constituted 47.0 per cent of total income, by 1935 the ratio has increased to 78.7 per cent.[18] (For elevator projects, only, the 1935 ratio stood at 69.1 per cent.)[19]

Another indication of a high level of operating expenses in relation to gross income was provided by New York State "Survey of Rents" which showed a 63.4 per cent ratio for 1949 based on a consolidated statement covering some 1,000 buildings[20] (the ratio for New York State excluding New York City was, interestingly enough, remarkably close, 64.6 per cent).[21]

A more recent analysis has been provided by Winnick who examined the records of certain FHA Section 608 projects.[22] The calculated 1955 operating expenses ratio for elevator properties in New York (actually the NewyYork-northeastern New Jersey standard metropolitan area) was 52.7 per cent; a similar ratio of 52.9 per cent was established for walk-up properties.[23]

Our own sample and the cases cited above should serve to qualify the observation of Greber, Blank and Winnick regarding the long-run decline in the ratio of net-to-gross income: the rapid decline noted by Grebler (Table 3-3) that accompanied the violent years of the Great Depression and the following World War had given way in the 1950s and in the 1960s--at least as far as the non-controlled residential housing sector in New York City is concerned--to a more stabilized situation in which the operating expenses ratio had risen moderately. Thus we find that Winnikk's 1955 ratio of operating expenses for FHA Section 608 elevator properties of 52.7 per cent was followed by the FHA Section 207

1964 sample ratio of 53.5 per cent, and the 1968 higher sample ratio of 55.5 per cent. The definite decline in the ratio of net to gross income witnessed during the period 1964-1968 thus falls into a long-run pattern of declines, a pattern which seems to have been rather steep in the 1930's and in the 1940's and noticeably milder ever since.

5. Relation of ratios to services provided. Several authorities suggested that operating ratios are related to the amount of services which are covered by rental payments; i.e., the more services are included, the lower should be the ratio of operating income to total revenue, and the higher is the corresponding ratio of operating expenses to revenue. Thus, according to Winnick, "other things being equal the more services provided, the lower will be the ratio of net to gross income."[24] This suggestion could be based on the assumption that successive increments of services do not require a proportional increases in investment in housing,[25] so that operating income may increase at a lesser rate, thus reducing the overall ratio of net to gross income. Winnick has offered the use of rentals per dwelling unit as a "rough gauge" of the quality of housing, and he could rely on at least one early source for partial support of this doctrine. An FHA study for 1935 (Table 3-4) shows a progressive increase in the operating expenses ratio as monthly revenue per room increases from the lowest level of $5.00 to $9.99 to the next to the highest level: $30.00 to $49.99.

TABLE 3-4

NEW YORK APARTMENT PROJECT OPERATING DATA FOR 1935 - 35 ELEVATOR PROJECTS

Revenue per Room per Month	Total Operating Expenses as a Percentage of Total Income
$ 5.00 to $ 9.99	59.1%
10.00 to $14.99	63.1
15.00 to $19.99	69.8
20.00 to $29.99	75.1
30.00 to $49.99	79.4
50.00 or more	63.8

Source: Federal Housing Administration, A Survey of Apartment Dwelling Operating Experience in Large American Cities, op. cit., p. 88.

TABLE 3-5

FHA SECTION 207 NEW YORK CITY SAMPLE--CLASSIFICATION OF OPERATING INCOME RATIOS BY AVERAGE ANNUAL RENT LEVELS FOR 1968

Ratio of Operating Income to Total Revenues	Average Annual Rent	
	Less than $2250.00	Over $2250
Arithmetic mean of sample	44.1%	44.9%
Confidence limits for the population mean:		
At 50% Confidence probability	43.5-44.7	44.1-45.7
At 80% Confidence probability	42.9-45.3	43.4-46.4

Source: FHA Section 207 New York City sample

The significant decrease, however, in the operating expense ratio of the highest class of $50.00 or more suggests that relatively high rentals may result from the existence of such factors as location and scenery which, unlike additional amenities, do not tend to increase operating expenses.[26]

Grebler, Blank and Winnick have repeated Winnick's suggestion,[27] stating that "there has been a long-run tendency for the number and value of facilities included in rent to increase,"[28] thus offering some explanation for the long-run fall in the ratio of net to gross income.

A broad classification of our FHA Section 207 sample by annual rent levels (Table 3-5) does not support the theory that with a higher level of services there is necessarily a decline in the ratio of operating income to total revenues. If rent levels are taken as an indication of services, the table shows in fact that it is possible for properties offering more services and commanding higher rents to preserve no less of their rent dollar for operating income than the lower rental properties do. This may be the case since improvement in services can be accomplished with only a moderate increase in operating expenses, or because other factors (such as a desirable location, etc.) help in commanding higher rents without a significant increase in services.

6. Comparison with other industries. The overall "creeping" decrease in the operating income ratio of FHA

Section 207 properties during the period 1964-1968 is not a phenomenon which is unique to New York City residential housing. If so called "profit margins on sales" in other industries are checked for the same period (Table 3-6) a mixed picture will be noted. Of the six industries listed, three major ones (manufacturing, transportation and public utilities) registered decreases in profit margins while the remaining three (mining, trade and services) recorded increases. A decrease was also noted for all the industries combined. Residential housing in New York City thus forms no exception to an economy-wide noticeable trend of "squeeze" on profits resulting from inflationary cost increases accompanied by a less rapid rise in revenues.

7. Cross-sectional analysis. A cross-sectional tabulation of the data (Table 3-7) reveals that as far as operating income ratios are concerned, it can be stated with 50 per cent confidence probability that Manhattan properties (all highrisers) had exhibited in 1968 a higher profitability than properties in the other boroughs (both highrisers and six stories). An interesting conclusion can be drawn from this observation: while highrisers may be handicapped by a lower operating income ratio, a Manhattan location can nevertheless help a highriser to overcome such a handicap and achieve a relatively high operating income ratio. This is apparently the result of the de-

TABLE 3-6

PROFIT MARGINS ON SALES OF LEADING CORPORATIONS FOR THE YEARS 1964 AND 1968

Industry	% Margin on Sales 1964	1968
Manufacturing	6.1	5.7
Mining	9.9	12.6
Trade	2.3	2.5
Transportation	6.5	4.8
Public utilities	13.9	13.0
Services	4.2	5.4
Construction	4.8	4.3
All industries combined	6.2	5.8

Sources: First National City Bank, Corporate Profits, April '65 and April '69

TABLE 3-7

FHA SECTION 207 NEW YORK CITY SAMPLE--A CROSS-SECTIONAL TABULATION OF MAJOR OPERATING RATIOS, 1968

Per Cent of Total Revenues	Manhattan All Highrisers	Other Boroughs Highrisers--Six Stories		Total All Boroughs Six Stories & Highrisers
Total Operating Expenses:				
Arithmetic mean of sample----------	53.6%	57.4%	56.0%	55.5%
Confidence limits for the population mean:				
At 50% Confidence probability.....	52.9-54.3	55.6-59.2	55.5-56.5	55.0-56.0
At 80% Confidence probability.....	52.3-54.9	53.9-60.9	55.0-57.0	54.5-56.5
Operating Income:				
Arithmetic mean of sample----------	46.4	42.6	44.0	44.5
Confidence limits for the population mean:				
At 50% Confidence probability.....45.7-47.1		40.8-44.4	43.5-44.5	44.0-45.0
At 80% Confidence probability.....45.1-47.7		39.1-46.1	43.0-45.0	43.5-45.5

Source: FHA Section 207 New York City sample

sirability of Manhattan residence versus the short supply of apartments in that borough.

Two sources who studied apartment buildings on the West Coast have pointed out the relatively low operating income ratio of highrisers.[29] Berger, who drew on an analysis of data collected in Los Angeles County in 1964, agrees with earlier authorities (Kingston, Clark and Thomsen) "that height increases were accompanied by decreases in building efficiency and increases in square-foot construction costs, indicating certain diseconomies of scale."[30] Berger's explanation of this phenomenon should hold true universally:

> The decrease in building efficiency associated with increasing height is largely due to the necessary expansion in the amount of building space devoted to non-income producing service area, most notably vertical transportation systems. Square foot construction costs tend to increase with increasing height beyond some poing essentially due to the impact of cost factors which increase on a square foot basis as height increases, such as the cost of structural frame, mechanical equipment, and the costs of transporting men and materials.[31]

Hedlund, in his study of apartment buildings in Alameda County in 1959-1960,[32] noted a decline in the gross rent multiplier as the number of rooms (as well as the number of dwelling units) in a building increases. He considers as a factor here the decline in the ratio of net to gross income since "operational costs increase with size because of the additional services required by the tenants

and the cost of management."[33]

An early FHA study, on the other hand, noted "that arrangement of the data in the New York sample by size of building showed a general tendency for larger buildings to be more profitable."[34] This seemingly conflicting evidence can now be explained by our sample; the early FHA study failed to distinguish between properties in Manhattan and those in other locations. The higher profitability of the larger buildings must have been due to the location of many of them in Manhattan; the record of those highrisers situated in other boroughs may well have been poorer.[35]

C. Individual Ratios: The Real Estate Tax Ratio

An analysis of individual operating expenses (Table 3-8) answers the very common question: "where did the rent dollar go." A detailed examination of each operating expense item would be very time and effort consuming and be of limited use for our needs. We have derived, however, ratios of several individual operating expenses which are based on the entire consolidated sample data without setting up confidence limits for the population means. The attention of public policy makers should thus be directed to major problem areas where remedial action should be taken--if indeed a check on growth of operating expenses is deemed desirable in order to help

TABLE 3-8

FHA SECTION 207 NYC SAMPLE-OPERATING RATIOS OF SELECTED INDIVIDUAL OPERATING EXPENSES FOR 1968

Operating Expense Item	Ratio of Operating Expense to Total Revenue
Real estate tax	24.0 %
Payroll of service personnel and related expenses	10.2
Repairs, maintenance and replacement	8.7
Administrative expenses	4.8
Fuel	2.3
Renting	1.4
Insurance	1.2

Note: Above ratios are arithmetic means based on the consolidated sample figures.

Source: FHA Section 207 NYC sample

TABLE 3-9

FHA SECTION 207 NEW YORK CITY SAMPLE
THE REAL ESTATE TAX: OPERATING RATIO, 1968

Average and Confidence Limits	Per Cent of Total Revenues
Arithmetic mean of sample.....	24.9 %
Confidence limits for the population mean:	
At 50% confidence probability.....	24.7-25.1
At 80% confidence probability.....	24.5-25.3

Source: FHA Section 207 New York City sample.

limit rent increase.

1. The significance of the real estate tax ratio. The municipal real estate tax emerges as the principal operating expense item constituting as it does approximately a quarter of the rent dollar (Table 3-9), (in terms of the "operating expense dollar" this tax consumes, of course, an even higher percentage: between 44 and 45 cents).[36] We will therefore direct our attention primarily to this tax; because of its magnitude as an operating expense and because it is the one operating expense item on which the public, through its elected officials, can exercise the most direct control.

The very significant portion of the real estate tax in the total revenue dollar has been noted for a long time, and Rapkin's finding in his New York City upper West Side study, that "real estate taxes constituted the single most important item of expenses,"[37] applies to many other studies as well. In attempting to draw attention to the weight of the tax, a government sponsored study stated that the local property tax "is tantamount to an excise tax on basic housing consumption of some 20 to 25 percent [percentage applied to the consumption expense exclusive of the tax]."[38] Our experience, however, would raise these figures--as far as many properties in New York City are concerned--to approximately 33 per cent.[39]

2. Comparison with other New York City properties. The approximately 25 per cent ratio (Table 3-9) is supported

by Rand[40] and, at 80 per cent confidence limits, its range includes the 25.3 per cent figure which was calculated by Sternlieb for 1967 for the non-controlled segment of his sample.[41] Sternlieb further shows that relatively recent rent-controlled structures (those built after 1929) had a similar though somewhat higher ratio, exceeding 26 per cent, while older buildings had much lower ratios of real estate taxes to revenue.[42] To the extent that the real estate tax expense reflects the market value of the property, we have here an indication of the depressed values of old rent-controlled apartment houses.[43] On the other hand, it may well be argued that such low ratios of real estate taxes for certain segments of the rent-controlled market, are actually a subsidy by the City of New York, granted to landlords, in order to help maintain relatively low-level rents in the face of constant rises in operating expenses.

The use of the real estate tax as a means of an indirect subsidy by the City to certain landlords (and through them to tenants) can be further demonstrated by a comparison of our 25 per cent operating ratio with those of certain publicly owned or publicly supported rental housing. A computation based on the financial statements of the New York City Housing Authority for 1968 shows that the expense item "payment in lieu of real estate taxes" constituted 6.4 per cent of total income.[44] A similar computation

shows that in the case of City-financed Mitchell-Lama Rental projects, the City has reduced over the years the share of the real estate taxes in the total revenue dollar, bringing it down from 21 per cent in 1957 to 16 per cent in 1967.[45] Such a step was clearly intended as a measure of aid by the municipality to tenants of moderate income due to a "persistent rise in rents and carrying charges."[46] It would, therefore, be neither alien to the philosophy and principles of city government, nor contrary to precedent, to argue for further utilization of the real estate tax as a public policy tool. (See Chapter VI).

3. Comparison with the tax ratio in the past. Upon examination of the historical record, several authorities have concluded that "there appears to have been an upward trend in the proportion of gross rents going toward the payment of local real estate taxes, at least in many urban localities."[47] This conclusion has been based to a large extent on Grebler's findings. As Table 3-10 demonstrates, there has been an unmistakable rise in the real estate tax operating ratio during the depression ridden 1930's. The ratio was subsequently stabilized and remained on a relatively high plateau during the rent control freeze years of World War II. Grebler attributes this phenomenon to "the notorious 'stickyness' of real estate taxes, i.e., the failure of taxes to adjust themselves fully to the lower gross income levels of the thirties and early forties."[49] Subsequent to the War,

TABLE 3-10

TAXES" - OPERATING RATIOS FOR NEW YORK CITY ELEVATOR APARTMENT HOUSES (FIVE-YEAR AVERAGES)

Period	Percent of Gross Income
1920-1924	16%
1925-1929	16
1930-1934	22
1935-1939	25
1940-1944	24
1945-1949	19
1950	18

Source: Grebler, Experience in Urban Real Estate Investment, op. cit., p. 255

TABLE 3-11

FHA SECTION 207 NEW YORK CITY SAMPLE--CLASSIFICATION OF REAL ESTATE TAX OPERATING RATIOS BY AVERAGE ANNUAL RENT LEVELS FOR 1968

Ratio of Real Estate Tax to Total Revenues	Average Annual Rent Less Than $2250.00	Over $2250.00
Arithmetic mean of sample	26.5%	23.2%
Confidence limits for the population mean:		
At 50% confidence probability.....	26.3-26.7	22.9-23.5
At 80% confidence probability.....	26.1-26.9	22.7-23.7

Source: FHA Section 207 New York City sample

as gross revenue increased, we did indeed witness a reduction from the unusually high ratio of the preceding decade and a half. There was, however, no full return to the low ratio of the 1920's.

A gradual yet persistent rise has thus come to characterize the secular trend of the operating ratio of the real estate tax to revenue.[50] Figures from the mid 1950's have confirmed the trend: Winnick's sample of FHA Section 608 elevator projects in New York City shows an operating ratio for real estate taxes in 1955 of 21.2 per cent,[51] while our own figures for 1968, as well as Sternlieb's figures for 1967, carry the trend further to an even higher ratio of approximately 25 per cent.

4. Comparison with properties outside New York City. A comparison of these ratios with the scanty data which is available for locations outside New York, shows the New York City real estate tax operating ratios to be somewhat higher than the other ones: Pifari and Fullerton provide an early 1960's ratio of 14.9 for San Francisco unfurnished properties, and a still lower ratio of 13.8 per cent for the several Bay Area counties combined.[52] Wendt and Wong, in their study of FHA Section 608 properties in the San Francisco Bay Area for the years 1952-1962, have computed the propety tax and insurance ratio to gross rent to be 19.4 per cent.[53] The impression that the operating ratio of the real estate tax to revenue in New York City is relatively high is further strengthened by a tabulation for 1968 by the Institute

of Real Estate Management, according to which the New York City ratio is higher than the respective regional ratios computed for the North, South and West, as well as the respective ratios for the United States and for Canada.[54] It would thus appear that the rent dollar of non-controlled apartment properties in New York City, is amongst the most heavily taxed shelter monies in North America.

5. Classification of the tax ratio by rent levels. A classification of the tax to revenues ratio by tax levels (Table 3-11) discloses that properties in the lower rent bracket have been burdened with a higher percentage of real estate taxes than those in the higher levels. This finding suggests that in the case of non-controlled properties the tax has assumed regressive rather than progressive features.[55] Furthermore, though the real estate tax ratio has been demonstrated to be amongst the higher ones in North America, there may still be room for its shifting between different properties in order to achieve a more equitable allocation of the overall tax burden.

6. Cross-sectional analysis. A cross-sectional tabulation (Table 3-12) reveals that despite increases in recent years, Manhattan properties (all highrisers) are still taxed at a relatively low rate of the revenue they generate. Six-story buildings--all in the other boroughs--are taxed the highest in terms of the revenue produced by them, while

TABLE 3-12

FHA SECTION 207 NEW YORK CITY SAMPLE--A CROSS-SECTIONAL TABULATION OF THE REAL ESTATE TAX OPERATING RATIO, 1968

Real Estate Tax Percent of Total Revenues	Manhattan All High-risers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total All Boroughs, Six-Stories & Highrisers
Arithmetic mean of sample-------	22.2%	25.6%	26.5%	24.9%
Confidence limits for the population mean:				
At 50% confidence probability....	21.9-22.5	25.4-25.8	26.3-26.7	24.7-25.1
At 80% confidence probability....	21.6-22.8	25.2-26.0	26.1-26.9	24.5-25.3

Source: FHA Section 207 New York City sample

highrisers in those boroughs occupy an intermediate position. As a result, if such taxation is to be measured as a percentage of revenue, highrisers all over the city are taxed less than six-story properties, and, rather surprisingly--if we are to use this criterion--Manhattan multi-family rental properties are taxed less than such properties in the other boroughs; despite the steep increases in the real estate tax expense of Manhattan properties per Table 2-19. The public policy implications of this situation will be discussed in Chapter VI.

NOTES TO CHAPTER III

[1]The use of ratios is common in financial statement analysis in general. Cost of goods sold, gross profit, general selling and administrative expenses, net income, etc., will all be expressed in terms of percentages of sales revenue when the so-called "vertical" analysis is undertaken.

[2]Assume, for example, that expense A constitutes 5 per cent of revenue and the remaining expense B equals 20 per cent of revenue. If expense A is expected to rise by 10 per cent over the next year while expense B is projected to increase by 15 per cent during the year, then total expenses will rise by $\frac{5}{5+20} \times 10\% + \frac{20}{5+20} \times 15\% = 14\%$ Since expenses have constituted 25 per cent of revenue, an increase in the latter of $\frac{14}{100} \times \frac{25}{100} = 3.5\%$ will suffice to cover the projected rise in expenses. This approach has been used by the New York City Rent Guidelines Board in determining "the magnitude of maximum rent increases which will be permitted under new renewal and vacancy leases of different lengths in dwelling units subject to the Rent Stabilization Law" during the period July 1, 1970 through June 30, 1971. See Statement of the Rent Guidelines Board Upon Issuance of Order Number 2: July 1, 1970 through June 30, 1971. Roger Starr, Chairman (Housing and Development Administration of the City of New York), news release, July1, 1970.

A similar approach was incorporated into the recent major revision of New York City's rent-control law which, starting in 1972 will provide for computerized calculations of allowable rent increases based on rises in weighted operating expenses. See "Council Passes Major Revisions in Rent Control," New York Times, June 28, 1970, p.1.

[3]There are several uses to this concept. Thus, for example, if the expected rent revenue is $100,000 a year (the figure could also be expressed on a per month basis) and the operating expense ratio is 45 per cent, then its complement, the operating income ratio equals 55 per cent, and operating income will amount to $55,000 a year. Given a desired return of 10 per cent per annum, a prospective purchaser would be willing to pay for the property $550,000. If, on the other hand, cost of the building is given as well as the rent revenue, then by applying the operating expense ratio, the resulting return will be computed. Another

possibility is that cost and desired return are given; by utilizing the expense ratio a determination can be made of the required rentals. The chart in the following page demonstrates the latter. It will be readily noticed that with an increasing expense ratio--say from 43 per cent to 52 per cent--the property will have to increase monthly gross rents from $1,100 to $1,300 in order to maintain a net return of 7 per cent.

[4]For a detailed exposition of the subject, see Louis Winnick, "Long-Run Changes in the Valuation of Real Estate by Gross Rents," The Appraisal Journal, XX, (October, 1952). Winnick states and develops two relationships between gross rents and market value (p. 485): "(1) Given equal capitalization rates (required rates of return on investment), the gross rent multipliers of any two properties or of the same property at two points in time are directly proportional to the ratios of net to gross income (2) Given equal ratios of net to gross income, the gross rent multipliers of two properties or of the same property over time are inversely proportional to the corresponding capitalization rates." The importance of operating ratios to property market values is made clear in the first relationship stated above.

[5]Assuming that capitalization rates have not decreased during the period; it is a safe assumption, in view of increases in returns on other modes of investment (Chapter V). See preceding note for more on the "rent multiplier."

[6]Sternlieb, Urban Housing Dilemma.

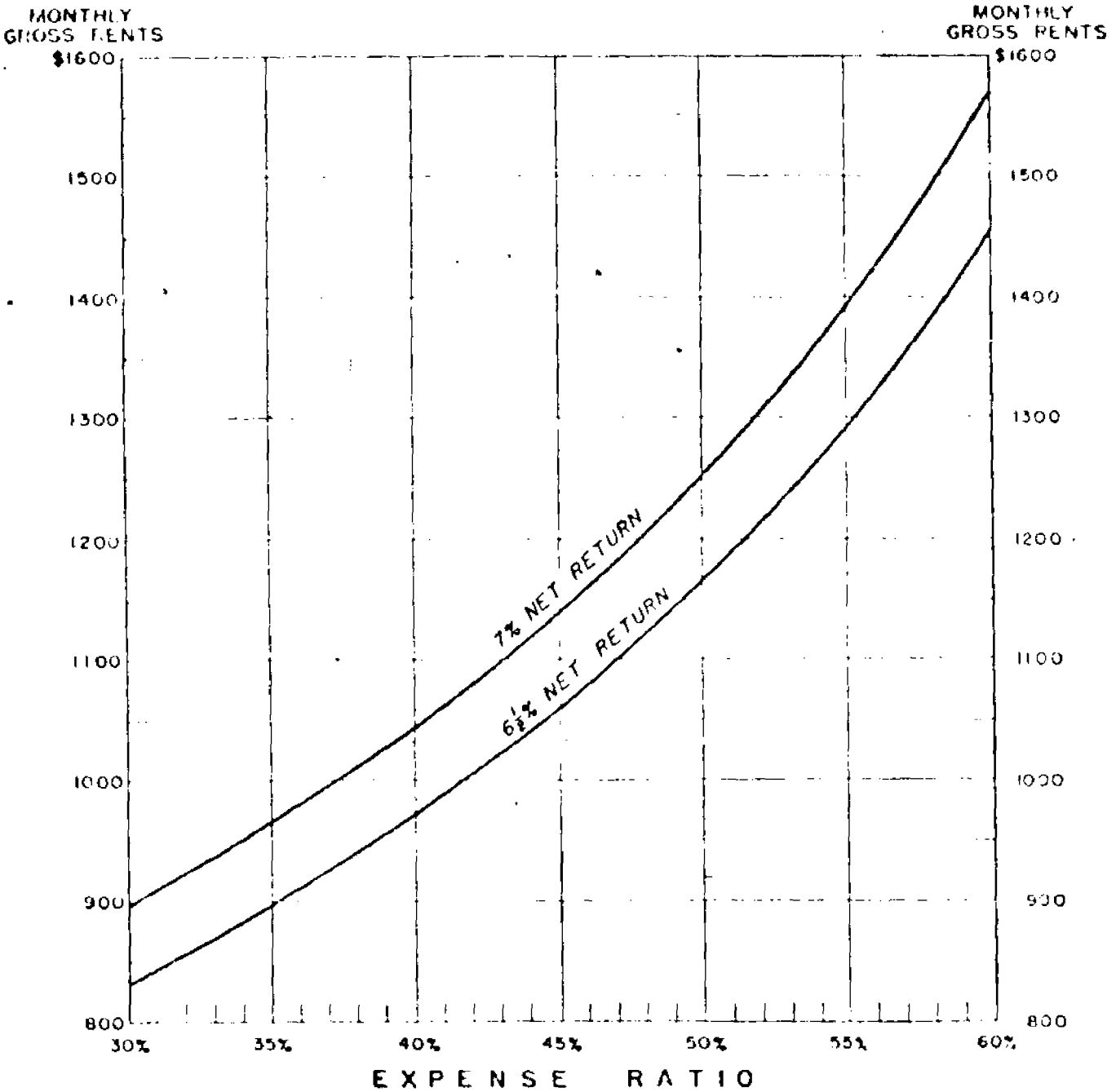
[7]Ibid., p. 377.

[8]There are of course different segments within the large rent-controlled sector with different records of performance. Thus the category consisting of structures built after 1929 with 50 units or more--a class of properties that both in physical characteristics and in age most resemble the non-controlled sector--exhibited the best operating income ratio by far, among all categories of controlled properties, getting closest to the operating income ratio of the FHA Section 207 sample; with a mean of 37.3 per cent and a median of 37.0 per cent. Ibid., pp.192 and 310 respectively.

[9]The problem of return to the equity owner will be explored in Chapter V.

[10]National Commission on Urban Problems, Building the American City, p. 427.

MONTHLY GROSS RENTS REQUIRED TO PRODUCE FIRST YEAR NET RETURNS OF 6½% AND 7% (AFTER AN ALLOWANCE OF 7% FOR VACANCIES AND COLLECTION LOSSES) AT VARIOUS EXPENSE RATIOS ON A PROPERTY COSTING $100,000



Source: Federal Housing Administration, How to Test Financial Soundness of Rental Housing, (Washington, D.C.: Government Printing Office, no date), p. 5.

CHART 1

FEDERAL HOUSING ADMINISTRATION
DIVISION OF RESEARCH AND STATISTICS
ACTUARIAL AND FINANCIAL SECTION

[11]A somewhat lower ratio of operating expenses, 52.5 per cent can be derived from the 1968 data for unfurnished elevator buildings in New York City, according to an annual compilation covering the United States and Canada. The figures are based, however, on a very small sample of 6 buildings whose owners volunteered the information. See Experience Exchange Committee, Income and Expenses Analysis, (1968), p. 15.

Our 1968 operating expenses ratio of approximately 55.5 per cent is closesly supported by the data available for 1967 on properties owned by City-financed Mitchell-Lama housing companies. Calculations show that after allowance has been made to increase the actual real estate tax expense of these properties, up to 25 per cent of revenue, similar to the experience of New York City FHA Section 207 apartment houses, the operating expenses ratio of the New York City Mitchell-Lama exceeded 54 per cent in 1967. See Kristof, "Rising Rents and Housing Costs in the City-Financed Limited Profit Housing Companies."

[12]Experience Exchange Committee, op. cit., pp.13-17.

[13]Wendt and Wong, op. cit., p. 636. It should be noted, however, that this study shows average operating ratios for the period 1952-1962; the actual ratios for the mid and late-1960's may vary from the figures presented.

[14]Grebler, Blank and Winnick, op. cit.

[15]Ibid., p. 414.

[16]Grebler, Experience in Urban Real Estate Investment, p. 93.

[17]Federal Housing Administration, A Survey of Apartment Dwelling.

[18]Ibid., p. 12.

[19]Ibid., p. 88.

[20]Temporary State Housing Rent Commission, Survey of Residential Rents and Rental Conditions, p. 99.

[21]Ibid., p. 198.

[22]Winnick, Opportunities for Private Investment, pp.271-286.

[23]Ibid., p. 279.

[24]Winnick, "Long-Run Changes in the Valuation of Real Estate by Gross Rents," p.488.

[25]Ibid.

[26]For further discussion of the 1935 FHA study, see Ernst M. Fisher, Urban Real Estate Markets: Characteristics and Financing, (New York: National Bureau of Economic Research, 1951), pp.104-105.

[27]Grebler, Blank and Winnick, op. cit., p. 416.

[28]Ibid., p. 417.

[29]Jay S. Berger, Occasional Paper No. 3--The Determination of the Economic Height of High-Rise Buildings, (Los Angeles: University of California, May 1968). Berger's study covers both apartment and office buildings.

[30]Ibid., p. 11.

[31]Ibid., p. 41.

[32]Donol Hedlund, "Survey of Gross-Rent Multiplier for Apartment Buildings in Alameda County 1959-1960," Bay Area Real Estate Report, (First Quarter, 1961), pp.25-30.

[33]Ibid., p. 29.

[34]Federal Housing Administration, Survey of Apartment Dwelling Operating Experience, p. 129.

[35]It is interesting to note that in later years, the Federal Housing Administration has recognized that bigger projects may be costlier to run for several reasons. See Federal Housing Administration, How to Test Financial Soundness, p. 16.

[36]These figures were recently supported by the June 1970 Report of the Bureau of Labor Statistics, according to which taxes, fees and permits constituted 45.5 per cent of operating costs in 1969. See U.S. Department of Labor, Bureau of Labor Statistics, Report on a Price Index of Operating Costs for Uncontrolled Apartment Houses in New York City, June, 1970, p. 7.

[37]Rapkin, The Real Estate Market in Urban Renewal, p.65.

[38]Patricia Leavey Hodge and Philip M. Hauser, The Federal Income Tax in Relation to Housing, (Washington, D.C.: The National Commission on Urban Problems, 1968),p.110.

[39]Twenty-five per cent of the revenue dollar means that the real estate tax adds 25 cents to what would otherwise be a rent bill of approximately 75 cents, an addition of 33.3 per cent to the rent charge exclusive of the tax. The combined New York City-New York State Sales Tax for 1968 was 6 per cent.

[40]Lowry, op. cit., p. VI.

[41]Sternlieb, Urban Housing Dilemma, p. 423.

[42]Ibid., It should be mentioned at this point that the figures published by the Institute of Real Estate management for 6 unfurnished elevator buildings in New York City in 1968 provide for ratio of the real estate tax to total actual rent collections of 20.6 per cent. This ratio seems rather low in light of our, as well as Sternlieb's, findings. It is possible, though, that these were old rent-controlled properties. See Experience Exhange Committee, op. cit., p. 15.

[43]The supposition that a higher operating ratio of the real estate tax to revenue indicates a higher market value for the real property and vice versa is supported by Rapkin's mid-1950's comparative data for old-law tenaments (walk-ups) on Manhattan's upper West Side: properties classified as in "good condition and well maintained" and presumably having a relatively high market value had a real estate tax operating ratio of 20.8 per cent, while properties classified as in "poor condition and poorly maintained," exhibited a much lower ratio of 15.0 per cent. See Rapkin, Real Estate Market in Urban Renewal, p. 72.

[44]New York City Housing Authority, Annual Fiscal Report, December 31, 1968, Exhibit B. Note that the 6.4 per cent ratio is even lower than the one mentioned by Welfeld who stated: "it is true that the Local Housing Authority makes 'payment in lieu of taxes', but such payment rarely exceeds 10 per cent of the shelter rents of the projects and is considerably smaller than expected tax revenues from new commercial, industrial, or residential development." See Irving H. Welfeld, "Toward a New Federal Housing Policy," The Public Interest, (Spring, 1970).

[45]Kristof, "Rising Rents and Housing Costs in City-Financed Housing."

[46]Ibid., p. 2. Increasing operating costs and interest costs were cited by New York City as the reason for a broadening of the partial real estate tax exemption of Mitchell-Lama developments. On Octobe 9, 1969 the City

granted unconditionally the maximum legal tax abatement (80%) to all state and City-financed Mitchell-Lama housing companies and redevelopment companies that were still in temporary financing. Previously, in 1967, the City of New York, in recognition of "sharp increases" in operating costs, recommended and the State of New York concurred and amended the Housing Finance Law removing the existing 50 per cent limitation on tax exemption. Thus, as operating expenses rose continually, so did the City resort to reduced real estate taxation to keep Mitchell-Lama rents within acceptable limits. For more on the subject see the following: press release by the Office of the Mayor (New York: September 19, 1969), (mimeographed); Housing and Development Administration circular by Jason R. Nathan, Administrator, "Revisions of the City's Mitchell-Lama Policies," (September 24, 1969); letter by Jason R. Nathan to the Board of Estimate, (October 1, 1969). Copies of these communications are available at the Municipal Library of the City of New York.

[47]Grebler, Blank and Winnick, op. cit. Rapkin has similarly noted that "since the beginning of the century, real estate taxes have taken an increasing share of the rent dollar." See Rapkin, "Role of Real Estate Taxes in the Investment Experience of Real Property," p. 491. Similarly, see Winnick, "Long-Run Changes in the Valuation of Real Estate," p. 490.

[48]Grebler includes in taxes certain payroll taxes in addition to the real estate tax. However, the weight of such miscellaneous charges must be minimal at most, since the bulk of Grebler's analysis extends over the period 1900-1950, years in which payroll taxes were either nonexistent or relatively low.

[49]Ibid., p. 95.

[50]A relatively low ratio for New York City rental properties in 1949 (16.4 per cent) was shown, however, in the consolidated operating statement appearing in a New York State survey. See Temporary State Housing Rent Commission, op. cit., p. 99.

[51]Winnick, Opportunities for Private Investment, p.279. Somewhat lower ratios for the mid-1950's were established by Rapkin in his study of the upper West Side, but this may have been due to the decay and deterioration that plagued the area depressing severely market values of local real estate. See Rapkin, Real Estate Market in Urban Renewal, p. 65.

[52]Ralph Pifari and Paul Fullerton, "Apartment Building Sales Analysis," Bay Area Real Estate Report, (Fourth

Quarter, 1963), pp. 26-28. It is interesting, however, that the authors calculated a ratio of the real estate tax to total operating expenses (46.0 per cent) which is similar to our sample ratio of 44-45 per cent.

[53]Wendt and Wong, op. cit., p.636.The ratio of the tax and insurance to total operating expenses is relatively low, 41.1 per cent.

[54]Experience Exchange Committee, op. cit., pp. 15, 18.

[55]For a discussion of the regressivity of housing taxation see Walter A. Morton, Housing Taxation, (Madison: The University of Wisconsin Press, 1955), p. 61.

CHAPTER IV

REVENUE AND OPERATING EXPENSES PER UNIT

A. Significance of Dollar Data on a Per Unit Basis

A determination of revenue, operating expenses and the resulting operating income in absolute dollar figures is highly necessary for several reasons. It can be done either on a per room or per apartment basis; the former, however, is more widely used, and it will be utilized in the following analysis,except for the calculation of rent which will be presented on a "per apartment" basis to allow for comparison with census data.

The present analysis is valuable in the public policy considerations for at least three reasons: there is, first of all, the need to know--prior to any legislative or administrative action on rent control or rent stabilization--whether present rent levels provide for adequate revenue to cover expenses or whether a deficiency exists that would bring about a "disinvestment" in housing (abandonment of rental properties by their landlords).[1] Secondly, the public policy makers are faced with the political and social issue of the relationship between rent levels and tenants' income: excessive rent increases may cause an intolerable rise in the rent to tenants' income ratio.[2] Thirdly, in the

area of specific expenditures, public officials may wish to ascertain the adequacy of outlays by landlords on maintenance and repairs since such a determination is especially called for prior to the approval of rent increases for rent controlled properties. Corresponding data based on the experience of non-controlled properties could thus be utilized as a yardstick against which the sufficiency of repairs and maintenance of controlled properties would be measured.[3]

Investors too require data in terms of dollar inputs and outputs: a calculation of revenue and operating expenses in absolute dollars provides the morggagee with an operating income figure which, from his point of view, is a means of measuring the ability of the property to sustain different amounts of debt servicing (including amortization of principal and payment of interest expense). If, on the other hand, the amount of debt servicing is fixed, then the larger the size of the operating income the bigger is the protection available to the mortgage holder; the operating income figure can indeed be expressed as a multiple of the required amount of debt servicing.[4] Similarly, the equity investor will utilize the operating income figure, subtracting from it the portion to be set aside for debt servicing, and arriving at a residual which is available for return on as well as recovery of his own investment in the property.

B. 1968 Rent Levels

An analysis of the FHA Section 207 New York City sample by rent levels (Table 4-1) yields a median monthly rent per apartment of $201.00 (and an arithmetic mean of $216.00); meaning that 50 per cent of the apartments rent for over $201.00 per month.

1. Comparison with other New York City properties. A comparison of the above mentioned figures with 1968 data, developed by the United States Bureau of the Census in its New York City Housing and Vacancy Survey, is of interest: for the never controlled sector as a whole--of which FHA Section 207 properties form a part--the median monthly rental was $161.00 and only 24 per cent of the units rented for $200.00 or more.[5] It is therefore evident that rents of FHA Section 207 apartments are well within the level obtained by the never controlled sector, which in turn is higher than the rent level applicable to the rest of the rental housing market in New York City. This impression is further strengthened upon a comparison of the above FHA Section 207 data with that of the great bulk of the City housing stock which is largely rent-controlled: the overall New York City median rental is $96.00 per month,[6] which is less than half the FHA Section 207 median of $201.00 per month; the controlled sector's median is even lower--$88.00 per month--[7] while the median monthly rent for public housing is $75.00 per month. It should also be noted that according to available data on the City-financed Mit-

TABLE 4-1

FHA SECTION 207 NYC SAMPLE-MONTHLY AND ANNUAL RENTS PER APARTMENT-1968

Percentiles	Monthly Rent	Annual Rent
25	$175.00	$2105.00
50	201.00	2417.00
75	261.00	3130.00
100	352.00	4229.00
Median	201.00	2417.00
Arithmetic mean	216.00	2598.00

Confidence limits for the population mean (rounded to nearest dollar):

At 50% confidence probability.....$2595.00-$2601.00
At 80% confidence probability..... 2592.00- 2604.00

Source: FHA Section 207 NYC sample

TABLE 4-2

FHA SECTION 207 NYC SAMPLE-A CROSS-SECTIONAL TABULATION OF MONTHLY AND ANNUAL RENTS PER APARTMENT, 1968

Rent Arithmetic Mean	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total All Boroughs Six-Stories Highrisers
Monthly	$ 264.00	$205.00	$168.00	$216.00
Annual	3166.00	2466.00	2018.00	2598.00
Confidence limits for the population mean (rounded to nearest dol				
At 50% confidence probability				
Annual.....	3162.00-3170.00	2463.00-2469.00	2016.00-2020.00	2595.00-2601.00
At 80% confidence probability				
Annual.....	3158.00-3174.00	2459.00-2473.00	2015.00-2021.00	2592.00-2604.00

Source: FHA Section 207 NYC sample

chell-Lama apartment buildings which are meant for moderate-income families,[9] the average 1967 monthly rent per unit amounted to $164.00 per month.[10]

2. Cross-sectional analysis. It is well known that rent levels are not uniform throughout New York City, but we are unaware of any prior study providing empirical data to that effect. Our findings (Table 4-2) show that in 1968 Manhattan properties have commanded an average monthly rent exceeding the average monthly rents in the other boroughs. The six-story properties in the other boroughs have commanded the least monthly rent: highrisers renting at a higher average were still below the Manhattan average. As a result, highrisers throughout the City of New York rented for higher amounts than six-story apartment buildings. These differentials in rent charges can hardly be explained on the basis of apartment sizes--the average number of rooms in highrisers' apartments both in Manhattan and in the other boroughs was 4.5 while the average number of rooms in six-story apartments was only slightly smaller: 4.3--and they must be attributed, therefore, to the superior attraction of a Manhattan location as well as the higher degree of amenities offered by highrisers in comparison to six-story apartment buildings.

C. The Rent-to-Tenants'-Income Ratio

Are the present rent levels of the non-controlled New

York City housing sector--of which FHA Section 207 properties form a part--working a hardship in terms of a "budgetary strain" on tenants? The answer to this important public policy question may be provided by an analysis of the rent-to-tenants' income ratio.

Based on census data, Niebanck has developed rent-income ratios (Table 4-3) which show a remarkable closeness in 1968 between controlled (21.0) and never controlled (21.4) units. It is worthwhile noting, however, that while the ratios for units in all categories have noticeably increased between 1960 and 1965, the increase between 1965 and 1968 was a much milder one, and in the case of the never controlled class, there was actually a slight decrease. A second analysis (Table 4-4) has led Niebanck to conclude that:

> Low income households (under $4,000), no matter how modest their needs might be, generally expend a quarter or a third or more of their incomes for housing. Middle and upper-income households (over $8,000), on the other hand, no matter how extravagant their housing tastes, typically spend no more than one-fifth of their incomes to secure satisfactory units.[11]

A situation in which low-income families are faced with a higher rent-to-income ratio (exceeding 25 and even 30 per cent) than that of middle and upper-income families (around 20 per cent), may suit "Schwabe's law",[12] but is in marked contrast to what is generally considered a desirable relationship between rent and income, namely: the higher the income the higher is the acceptable rent-to-income ratio.[13] Recent calculations by the Bureau of Labor Statistics suggest that low-income families ("lower standard") should spend no more than

TABLE 4-3

MEDIAN GROSS RENT/TENANTS' INCOME RATIO, NEW YORK CITY, 1960, 1965 AND 1968

	1960	1965	1968
All rental units reporting	18.7	20.4	21.0
Controlled	17.7	19.7	21.0
Decontrolled	20.8	21.9	22.4
Never controlled	20.0	21.5	21.4

Source: Niebanck, op. cit., p. 165

TABLE 4-4

GROSS RENT AS A PER CENT OF INCOME, NEW YORK CITY, 1968

Income of Families & Individuals	Total Reporting %	Total Reporting #	Gross Rent as a Per Cent of Income: Less than 15%	15-19%	20-24%	25-34%	35% or more
Less than $2,000	100.0	116,712	0.1%	0.0%	1.1%	6.0%	92.8%
$2,000-2,999	100.0	94,374	0.5	1.7	6.5	25.5	65.8
$3,000-3,999	100.0	116,936	2.5	10.7	21.1	37.6	28.1
$4,000-5,999	100.0	240,252	8.6	29.9	28.3	23.6	9.6
$6,000-7,999	100.0	194,550	28.5	33.8	18.8	15.8	3.1
$8,000-9,999	100.0	127,887	46.4	26.9	17.9	6.8	2.0
$10,000-14,999	100.0	155,325	55.0	27.2	11.6	4.7	1.6
$15,000-& over	100.0	82,428	72.6	16.8	6.3	2.9	1.4

Source: U.S. Bureau of the Census, New York City Housing and Vancancy Survey 1968, Cited by Niebanck, Rent Control and the Rental Housing Market-New York City 1968, p. 166. (per cents only; other data extracted by the writer directly from Series III, Table E21, p. 1 of the Survey.)

19.6 per cent of their budget on housing, while middle-income families ("intermediate standard") may spend up to 24.9 per cent, and upper-income households ("higher standard") may spend as much as 25.6 per cent.[14]

In the light of the above, and considering the fact that approximately 50 per cent of the households occupying never controlled units in 1968 earned $10,000 a year or more, while over 20 per cent earned $15,000 or more,[15] the answer to the question posed earlier is: from the available data it seems that 1968 rents in the non-controlled sector, including FHA Section 207 projects,[16] posed no budgetary strains by themselves on occupants of these properties, since these tenants were faced with a rent-to-income ratio of approximately 21 per cent; well below the 25 per cent which would be deemed comfortable for upper-middle-income households.[17] Under the terms used in this analysis,[18] hypothetical rent increases up to a maximum of 19 per cent--bringing the rent-to-income ratio from 21 to 25 per cent--would have still been possible without working a hardship on tenants.

D. Individual Items on a Dollars-Per-Room Basis

A dollar analysis on a per room basis (Table 4-5) shows that on the average, the monthly revenue per room amounted to $51.00, of which operating expenses consumed an average of $28.00; providing an average of $23.00 for operating income, which is available for debt servicing as well as a

TABLE 4-5

FHA SECTION 207 NYC SAMPLE-REVENUES, REAL ESTATE TAX, OPERATING EXPENSES AND INCOME PER ROOM[a], PER MONTH, 1968

	Arithmetic Mean	Confidence Limits for the Population Mean	
		At 50% Confidence Probability	At 80% Confidence Probability
		(Rounded to the Nearest Dollar)	
Revenues	$51.00	$50.00-52.00	$50.00-52.00
Real estate tax	12.00	12.00-12.00	12.00-12.00
Other operating expenses.....	16.00	16.00-16.00	16.00-16.00
All operating expenses.....	28.00	28.00-28.00	27.00-29.00
Operating income	23.00	23.00-23.00	22.00-24.00

(a) To arrive at amounts per apartment multiply by 4.4 (average number of rooms per apartment)

Source: FHA Section 207 NYC sample

return to the equity investor. Whether operating income of such magnitude is sufficient to provide the necessary protection to the lenders (holders of mortgages) will depend, of course, on the specific debt structure which may apply to a particular building. The overall problem of return on investment will be treated in Chapter V.

The picture of operating expenses emerging from Table 4-5 is of interest. The McKay committee has stated that: "based on 1968 data there is considerable agreement that there is no part of the sound or salvageable housing inventory in New York City that can be operated at reasonable maintenance levels for less than $20.00 [per room] per month. Some believe that $25.00 is a more realistic figure."[19] Table 4-5 shows that neither $20.00 nor $25.00 would have sufficed to cover operating expenses of FHA Section 207 properties in New York City--at the level on which they were actually maintained and operated in 1968. It should be emphasized, however, that of the $28.00 of operating expenses, $12.00--the real estate tax--was "thrust" upon management as a mandatory charge by the city, while the remaining $16.00 of other operating expenses (repairs, maintenance, etc.) leave a degree of discretion to the landlord. The decision to spend more or less on the latter attests to the existence or lack of factors such as: the shortage of housing (all other things being equal, the more pressing the shortage the less would be the amount of services required of management in order to maintain reasonably full occupancy) and the confidence of

the landlord in the future prospects of his investment (in a given situation, the bigger the confidence the larger the readiness of management to invest in the proper maintenance of the property.)[20] It is therefore valuable to compare the 1968 dollar expenses per room of FHA Section 207 properties with other, similar, current data.

1. Comparison with other New York City properties. A total monthly operating expense of $28.00 per room (Table 4-5) is almost identical with the annual figure of $344.00 per room (or $29.00 per month) calculated by Sternlieb's for his 1968 non-controlled sub-sample.[21] Sternlieb's detailed analysis shows rather predictably that expenses for non-controlled properties exceeded those of the controlled ones; and in the latter category it is the newer and bigger units (structures built after 1929 with 50 units or more) that exhibited the highest level of expenses: an annual figure of $236.00 per room (or $20.00 per month) is nevertheless well below the corresponding figure for the non-controlled properties. A similar situation emerges after an allowance has been made for the mandatory item of real estate taxes: Sternlieb shows an annual tax figure of $167.00 per room (or $14.00 per month) for the non-controlled sub-sample,[22] leaving an annual amount of $178.00 (or $15.00 per month) for discretionary expenses similar to the $16.00 of FHA Section 207 properties. While the controlled structures, built after 1929 with 50 units or more,[23] had a lower annual real estate tax expense of $99.00 (or $8.00 per month)

leaving an annual amount of $136.00 (or $11.00-$12.00 per month) for discretionary expenses (repairs, maintenance, etc.), which is well below the amounts spent on operation and maintenance of non-controlled properties; it nevertheless exceeds operation and maintenance outlays for other categories of the controlled properties. We may therefore conclude that, based on larger outlays per room for operation of non-controlled apartment buildings, owners and managers of those properties demonstrated a greater degree of financial ability, as well as confidence in the future, compared with the ownership and management of the different categories of controlled buildings.[24] Furthermore, if a diminished size of outlays on operation and maintenance may indicate possible contemplation of abandonment of property by its owners, then such action is least entertained by those managing non-controlled apartment buildings who proved their positive intentions by spending sizable sums on operation and maintenance for the benefit of tenants. While the reasons for abandonment may be complex and numerous, the significance of the above observation should not be lost on the public policy makers of New York City which has been plagued by a severe abandonment phenomenon.[25] The public policy implications of the above will be further analyzed in Chapter VI.

2. The effect of real estate tax on operating expenses. A comparison of the FHA Section 207 sample with rental properties enjoying various degrees of tax exemptions, will fully reveal the extent of the effect of the real estate tax on

total operating expenses: Kristof has calculated total 1967 operating expenses per room, per month, for New York City-financed Mitchell-Lama rental projects at $17.00[26], well below the 1968 figure of $28.00 for the FHA Section 207 properties (Table 4-5); but approximately half the difference is due to the lower real estate tax--$6.00 rather than $12.00--which was applicable to the Mitchell-Lama properties.[27] In the case of New York City Housing Authority, total monthly expenses in 1968 amounted to $77.00 per dwelling unit,[28] which is $47.00 below the 1968 monthly operating expenses per apartment for FHA Section 207 properties of approximately $124.00 ($28.00 per room times 4.4 rooms per apartment). Included in the $77.00 figure, however, is "payment in lieu of real estate taxes" in the amount of $5.00,[29] which is $49.00 less than the $54.00 monthly real estate tax expense per apartment, incurred by FHA Section 207 apartment buildings in 1968 ($12.00 per room times 4.4 rooms per apartment). Having thus isolated the effect of the real estate tax, we find that the Housing Authority has incurred discretionary expenses no smaller that those applicable to the FHA Section 207 properties.[30]

3. Comparison with properties outside New York City. The scanty current data available for areas other than New York City unfortunately does not allow for an extensive comparison. One compilation for 1968 shows the United States with average annual expenses per room for unfurnished elevator buildings of $296.00, and Canada with $258.00. The

tabulation further shows that among the different regions in this country, the North is burdened with the highest figure, $301.00, while the South is next, with $289.00, and the West has the least annual expenses per room, $269.00.[31] FHA Section 207 properties in New York City have therefore incurred operating expenses ($28.00 X 12 = $336.00) well above the North American average; a phenomenon that may have several reasons, not the least among them, is the fact that in comparison to the rest of the United States, New York City is a high cost area.

4. Cross-sectional analysis. A cross-sectional tabulation of the data on revenue, operating expenses and income (Table 4-6) reveals that both revenues and operating income per room for Manhattan properties, surpass those of all other properties in the other boroughs be they highrisers or six-stories. Highrisers in the other boroughs, however, fare somewhat better than the six-story units with regard to revenue per room, but the differential in operating income between the two classes is much smaller, due mostly to the higher other operating expenses per room for the highrisers. Two important observations suggest themselves to public policy makers: (a) with higher revenues per room, landlords do spend more on discretionary expenses (other operating expenses) per room in absolute dollars, though not necessarily in such manner as to maintain a constant ratio of expenses to revenues for all categories of properties. It thus appears that the higher the revenues a proper-

TABLE 4-6

FHA SECTION 207 NYC SAMPLE-A CROSS-SECTIONAL TABULATION OF MONTHLY REVENUES, REAL ESTATE TAX, OPERATING EXPENSES AND INCOME PER ROOM [a], 1968

	Manhattan	Other Boroughs		Total
	All Highrisers	Highrisers	Six-Stories	All Boroughs, Six-Stories & Highrisers
Revenues				
Arithmetic mean	$ 60.00	$ 48.00	$ 42.00	$ 51.00
Confidence limits for the population mean (rounded to nearest dollar):				
At 50% confidence probability.....	$ 59.00-61.00	$ 47.00-49.00	$ 42.00-42.00	$ 50.00-52.00
At 80% confidence probability.....	$ 59.00-61.00	46.00-50.00	41.00-43.00	50.00-52.00
Real Estate Tax				
Arithmetic mean	$ 13.00	$12.00	$ 11.00	$ 12.00
Confidence limits for the population mean (rounded to nearest dollar):				
At 50% confidence probability.....	$ 13.00-13.00	12.00-12.00	11.00-11.00	12.00-12.00
At 80% confidence probability.....	$ 13.00-13.00	12.00-12.00	11.00-11.00	12.00-12.00

TABLE 4-6
(cont'd)-2

	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total All Boroughs, Six-Stories & Highrisers
Other Operating Expenses				
Arithmetic mean	$ 19.00	$ 16.00	$13.00	$16.00
Confidence limits for the population mean (rounded to nearest dollar):				
At 50% confidence probability.....	$ 19.00-19.00	16.00-16.00	13.00-13.00	16.00-16.00
At 80% confidence probability.....	$ 19.00-19.00	16.00-16.00	13.00-13.00	16.00-16.00
All Operating Expenses				
Arithmetic mean	$ 32.00	28.00	24.00	28.00
Confidence limits for the population mean (rounded to nearest dollar):				
At 50% confidence probability.....	$ 32.00-32.00	27.00-29.00	24.00-24.00	28.00-28.00
At 80% confidence probability.....	$ 31.00-33.00	26.00-30.00	23.00-25.00	27.00-29.00

TABLE 4-6
(cont'd)-3

	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total All Boroughs, Six-Stories & Highrisers
Operating Income				
Arithmetic mean	$28.00	$ 20.00	$ 18.00	$23.00
Confidence limits for the population mean (rounded to nearest dollar):				
At 50% confidence probability.....	$28.00-28.00	$ 19.00-21.00	$ 18.00-18.00	$23.00-23.00
At 80% confidence probability.....	$27.00-29.00	$ 18.00-22.00	$ 17.00-19.00	$22.00-24.00

(a)
To arrive at amounts per apartment multiply by average number of rooms per apartment as follows: Manhattan; Other Boroughs-Highrisers: 4.5
Other Boroughs - Six Stories: 4.3
Total All Boroughs, Six Stories and Highrisers: 4.4

Source: FHA Section 207 NYC sample

ty commands, the greater are its chances to be better maintained, since landlords, rather than "pocket the extra monies,"[32] do seem to spend more on such apartment buildings. (b) The difference in the real estate tax per room for the different categories of properties--despite the more pronounced increases of recent years which applied to Manhattan apartment buildings--is still negligible. Using the ratio of the real estate tax to revenues as an indicator of the tax load, Manhattan properties could tolerate a monthly tax increase of $2.00-$3.00 per room and not be burdened with a heavier tax load than that of the six-story buildings in the other boroughs.[33] Obviously, there is room for change in the distribution of the real estate tax load, as will be indicated in Chapter VI.

NOTES TO CHAPTER IV

[1]Thus, according to Rand, "most City programs dealing with problem buildings are not equipped to treat a basic deficiency, inadequate revene." See Lowry, op. cit.,p.VII. Similarly, in regard to New York City rent-controlled properties, Sternlieb concluded that "total dollar operating revenues before debt service or depreciation, from the structures most in need of investment is very small." See Sternlieb, Urban Housing Dilemma, p. 47.

In a very somber description of the problem and its consequences, Mayor Lindsay stated that "a large number of habitable apartments are reduced to shambles or withdrawn from the market because in poorer areas rents families can afford to pay do not even meet the operating and maintenance expenses of the buildigg. The terrifying fact is that in New York City more housing is being withdrawn from the market than added to it." See full statement of Honorable John V. Lindsay, Mayor of the City of New York, before the House Banking and Currency Committe, February 2, 1970. Press release by the Office of the Mayor, (New York: February 2, 1970), (mimeographed).

[2]The customary use of the rent/income ratio was explained as follows:

> "It is customary, in most housing market analysis, to assess the performance of the market in part through the use of the ratio of gross monthly rent expenditures to monthly income. Intuitively, this ratio is appealing as a tool for summarizing the situation. If a household has a very high rent/income ratio, it is concluded that the household is paying more than it should (or earning less than it needs) to pay for adequate housing without sacrificing other necessary items consumption. If a household has a low rent/income ratio, on the other hand, the conclusion generally is either that the cost of its housing is unusually low, or that its income is so high as to permit it to satisfy its residential needs with a modest proportion of its total budget."

See Niebanck, op. cit., pp. 162-163. The political and social consequences of a high rent/income ratio can be awsome in light of the great number of tenants in the City of New York.

[3]For a use of this approach to measurement of repairs and maintenance expense in rent-controlled properties,

see Sternlieb, Urban Housing Dilemma, pp. 482-483.

[4]Fisher has already pointed out that income-property loans (such as loans on apartment houses) resemble business term loans more closely than they do home loans because of their heavy reliance on projected "flows of income rather than on the value and marketability of the collateral as a means of protecting the lender's investment." Robert Moore Fisher, "Special Economic Aspects of Mortgages on Income-Producing Properties," p. 99

[5]U. S. Bureau of the Census, New York City Housing and Vacancy Survey, 1968. For citation of data and its analysis, see Niebanck, op. cit., pp. 43-45 especially. It should be noted that the census was taken in April, 1968, thus reflecting rent levels in force during the early part of the year, while our figures apply to 1968 as a whole. A census taken later in 1968 might have resulted in somewhat higher rents.

[6]Ibid., p. 43.

[7]Ibid.

[8]Ibid.

[9]According to New York State Senator Manfred Ohrenstein, the Mitchell-Lama program is supposed to serve moderate-income families "earning between $7,000 and $15,000 per year." See press release of the Office of the Mayor (New York: September 19, 1969), (mimeographed).

[10]Kristof, "Rising Rents and Housing Costs," p. 11.

[11]Niebanck, op. cit., p. 167.

[12]The old "law" states that "the higher the income the lower the proportion of income going to housing." Cited in Reid, op. cit., Reid proceeds, however, with a spirited refutation of this "law," drawing on census data up to 1960, and utilizing Milton Friedman's permanent-income theory of consumption (which differentiates between consumption changes that are due to short-term income changes and those that result from long-term changes in income), she finds high quality housing to be one of the important luxury components of the American standard of consumption (p. 7), concluding that while housing consumption is little affected by short-run fluctuations in income, the ratio of housing to income does tend to rise with normal income. (pp. 387-388.).

[13]It should be noted, however, that the inequity in the rent load is corrected somewhat through income taxation:

the tax "bite" at the $15,000 and over bracket is sizable.

[14]See U.S., Department of Labor, Bureau of Labor Statistics, Some Facts Relating to Earnings and Wages in New York City, (March, 1970)
Percentages were derived from Spring,1969, data appearing on p. 19. Similar ratios have been mentioned before, and there seems to be a general consensus about their desirability within not too wide a range: the Public Housing Act of 1949 requires that rent paid by low-income families should equal one-fifth of their current income. Calculations by Kristof regarding moderate-income families in Mitchell-Lama properties assume that at an annual gross rent of $2,253 per year "the lowest income a family reasonably could have to afford this housing would be $9,000 per year" which is a rent-to-income ratio of 25 per cent. See Kristof, "Rising Rents and Housing Costs," p. 2. A maximum ratio of 25 per cent is mentioned much earlier by Sherman J. Maisel, "Policy Problems in Expanding the Private Housing Market," American Economic Review, XLI, (May, 1951), p. 605.

[15]U.S. Bureau of the Census, New York City Housing and Vacancy Survey, 1968; reproduced by Niebanck, op. cit., p.94.

[16]No separate tenants' income data are available for Section 207 properties. However, since these residential units constitute a part of the never controlled sector--with corresponding rent levels as demonstrated in the text (p. 137)--it would be appropriate to assume that occupants of Section 207 dwellings earned incomes resembling those of other households in the non-controlled housing sector as indicated by the 1968 figures of the United States Bureau of the Census.

[17]This observation would seem to fit in with long-run developments that have led some to conclude that there "is impressive evidence that housing has moved downward in the consumer's scale of preferences." Having analyzed the United States record for the period 1890-1950, Grebler, Blank and Winnick further suggested an "apparent cut in the slice of family income now being spent for housing." While finding "no evidence that there has been a long-run decline in the ratio of rent to income," they nevertheless emphasize the point that with the passage of time "an increasing proportion of the aggregate rent bill represents the cost of services other than that of pure shelter-services related to the operation of a household as encompassed in a modern standard of living." See Grebler, Blank and Winnick, op. cit., pp. 131,132,133 respectively, as well as the rest of Chapter VIII which is suggestively titled: "Have Consumer Prefernces for Housing Weakened?"

[18]See, however, note 13 above, regarding modification introduced through income taxation.

[19]Report to the Mayor on an Investigation into Rental Increases in the Non-Controlled Housing Market, p. 32.

[20]Sternlieb, for example, concluded in this context that: "it is difficult to exaggerate the influence of area in landlord decision making." Sternlieb, Urban Housing Dilemma, p. 853.

[21]Ibid., p. 478.

[22]Ibid., p. 476.

[23]Ibid.

[24]This analysis could be carried further, but the results would be similar: for his full 1967 sample of controlled properties, Sternlieb shows mean annual repair costs per room which do not exceed $42.00 (Ibid., p. 188) and mean annual repair costs per apartment which do not exceed $188.00 (Ibid., p. 189). The corresponding figures for the FHA Section 207 sample are noticeably higher: $53.00 and $233.00 respectively, demonstrating the higher level of care and maintenance which are bestowed upon non-controlled properties.

[25]The Rand Institute sees the abandonment problem as further aggrevated by the fact that "recent losses are not confined to the worst part of the stock as is usually the case. At least 80 per cent of the unrecorded losses of the last three years (1965-1967) were units in buildings classified in 1965 as either sound or deteriorating but not dilapidated." Lowry, op. cit., p. 6.

[26]Kristof, "Rising Rents and Housing Costs," p. 11.

[27]Ibid.

[28]New York Housing Authority, op. cit., p.

[29]Ibid.

[30]It is worth noting in this connection that for 1968 the New York City Housing Authority shows a net deficit of $44.00 per dwelling unit per month, $42.00 of which are covered by what is listed as a "subsidy." Ibid. Considering, however, the very small payment in lieu of real estate

taxes, one may claim that had the foregone taxes been accounted for, the deficit and the subsidy would have been approximately twice as large.

[31] Experience Exchange Committee, op. cit., p. 18.

[32] This conclusion is reinforced upon further analysis of the repairs, maintenance and replacement figures by themselves: the monthly figure per room for Manhattan properties is $5.00 and the other categories follow in a descending order, $4.00 for highrisers in the other boroughs and $3.00 for six-story apartment houses in those boroughs.

[33] An application of 26.5 per cent (the 1968 sample) real estate tax operating ratio for six-story buildings in the other boroughs (shown in Table 3-12) to Manhattan (1968 sample) monthly revenues per room of $60.00 (shown in Table 4-6) yields $15.90 or $2.90 above the actual (1968 sample) monthly real estate tax per room for Manhattan properties of $13.00 (shown in Table 4-6).

CHAPTER V

RETURN ON INVESTMENT

A. Significance of Return on Investment

An investment in rental housing--like any other investment--is subject to a crucial test of financial success, namely: the rate of return earned on it. An actual determination of the return is a technical matter of measurement which should be undertaken once the specific yardstick among the several available measures has been selected. The sufficiency of a return thus determined may then be judged through comparative analysis, which considers a variety of factors such as: available return on alternative investments, degrees of risk associated with different investment opportunities, etc. Wendt and Cerf correctly stated this in a recent work:

> The rate of return provides the principal criterion for most investment decisions. Investment returns can be regarded as a continuum of rates reflecting the relative degrees of risk, management skill, and other criteria of attractiveness associated with investments in bonds, stocks, ships, real estate, or other productive assets. [1]

The Federal Housing Administration has similarly recognized

that:

> The value or rental properties arises from their ability to return the capital invested as well as pay a return in the form of interest on the investment at a rate set by the competition of capital seeking investment. The problems of management and relative risk involved in various types of investments are prime factors in establishing the rate of return the market demands. [2]

Prospects for a satisfactory return (or yield) on investment without doubt provide the "sine qua non" in real estate investors' decisions, be they investors in debt instruments (mortgages) or owners of the equity. Considerations of property return must therefore precede all others, because a property yielding a sufficient return would provide the necessary and the best protection to the mortgagee and, at the same time, leave a satisfactory residue for the equity owner. If, on the other hand, a property cannot command a minimal yield, the position of the holder of a debt instrument on it will be shaky at best, and the return to the owner of the equity interest will be unsatisfactory no matter how low is the debt servicing burden (the latter consisting of amortization of the mortgage principal and payment of interest thereon). Mention of this point has been made in the housing literature on m ore than one occasion, yet the issue has recently been somewhat clouded by a noticeable tendency to blame the lack of new residential construction on the high cost of mortgages. Let it therefore be stressed that a sufficient return on peoperty will--by definition--accommodate even a high-interest

debt.[3]

The sufficiency of the return on investment in multi-family rental housing New York City has in recent years assumed the characteristics of a major public policy issue. In addition to investors in realty, the public officials have attempted to determine whether the yield on such investment is competitive with those earned by alternative investments after consideration has been given to differences in risk, etc. This comparative analysis has resulted by and large in findings which were far from bright, regarding the desirability of investment in New York City rental housing. Grebler--in his well-known study which extended over most of the first half of this century--has concluded that "net returns on long-term investments in the properties included in this study have been lower than one would expect considering the risks involved in real estate investment."[4] He went on to suggest that public policies "can be so designed or executed as to encourage or discourage responsible long-term equity investment in real estate."[5]

The rent-controlled sector has been found to provide unsatisfactory yields according to Sternlieb, who stated as his first "principal finding" that "current operating yields for the most part are substantially below alternative investment yields."[6] The New York City Rand Institute arrived at similar conclusions and furthermore pointed out the grave

consequences to the public at large:

> Their [the landlords'] efforts to maintain yields in this situation lead to under-maintenance and declining building services-operating policies that antagonize their tenants and, over the long run, consume the City's housing stock without replacement. [7]

The need to maintain a sensible parity between yields on rental housing and those earned on other investments is indeed ever present, especially in view of the fact that there are available, practically at all times, many other investment opportunities, including the growing demand for American funds abroad.[8] That such parity should be maintained in the interest of a continuous and a vigorous long-term investment program in rental housing has been acknowledged recently by the Rent Guidelines Board of the City of New York, which establishes the magnitude of maximum rent increases that will be permitted under new renewal and vacancy leases in rental units subject to the Rent Stabilization Law (non-rent controlled multi-family rental dwellings). The Board has explained that an "accross the board" increase affecting all leases--in addition to other specified increases depending upon lease renewals of different lengths--was "designed as a stabilizer to equalize changes in the yield on capital invested in real estate governed by Rent Stabilization Law with changes in the yields paid by other long-term investments."[9]

The history of equity investment in rental housing by life insurance companies offers an extremely valuable les-

son regarding the all-important role of a sufficient return on investment. It appears that after an early beginning in the 1920's, which was primarily motivated by the desire to answer pressing social needs, thus creating popular goodwill towards life insurance companies, and after New York State pioneered statutory revisions allowing the companies a significant equity investment in housing, a massive investment program had indeed been undertaken during the twelve-year period, 1941-1952, as a result of which numerous large housing projects were added to the housing stock of New York City. The program, a highly beneficial one, as far as the housing needs of the City were concerned, was realized because of bright expectations for a sufficient return on investment which were accompanied, in certain cases, by a municipal real estate tax exemption of limited duration, and authorized by State legislation. Another factor providing incentive was the significant spread between yields on equity investment in existing rental housing, and those available on investments in high-grade bonds, as well as mortgage loans. Subsequent experience, however, has been disappointing: the return on equity investment in rental housing undertaken in the post-World War II period fell below expectations. As a result, there were no new undertakings after 1952, followed by a process of divestiture with many of the existing projects being sold by the life insurance companies.[10] It was clearly a case of insuffi-

cient yields--rather than legal ceilings on equity investment in rental housing, which were far from being reached--that put in jeopardy, if not totally terminated, the housing program of the life insurance companies.[11] Bearing in mind the vast financial assets under the control of these companies, it is evident that the public interest will be served significantly by a resumption of equity investment in New York City rental housing by life insurance companies; higher and competitive yields on investment will apparently best spur the companies into a renewed interest in housing.[12]

Significant emphasis on the weight of yield considerations was also noted in response to a questionnaire circulated by the author early in 1970, among actual and potential investors in rental housing in New York City; life insurance companies, commercial and savings banks, and large realtors. Of the twenty five respondents, fourteen pointed to "insufficient net income" as a cause in their answer to the question: "Assuming the existence of a New York City housing shortage, what are the reasons for it?"[13]

A note of caution which may possess some public policy implications is called for at the conclusion of this introductory discussion of the return on investment in multi-family rental housing in New York City. The analysis in the following pages is understandably--as all investment analyses based on past records would be--an ex post facto one, showing what the actual return was. The problem facing

a potential investor in housing, as well as investors in general, however, is much more complex, being ex ante by nature; he has to determine what rate of return on the prospective investment could be expected in the future, and whether such a rate is to be deemed satisfactory in view of the current rate of return on available alternative investments, as well as the latter's expected movement in the future. Furthermore, as pointed out by Winnick,[14] expectations of capital gains or losses play an important role in investors' decisions regarding the sufficiency of the current annual rate of return on investment. If a substantial capital gain is expected, then a relatively low current rate--one that may fall even below that earned on alternative "riskless" investments (high-grade bonds for example)--will be accepted but if, on the other hand, no such gains are to be expected or the possibility of a capital loss looms in the foreseeable future, then a relatively high current rate of return will definitely be sought, with the resultant temptation to raise rents above socially acceptable levels and/or cut service expenses. It may well be therefore, that New York City rent control legislation combined with the more recently enacted rent stabilization legislation covering pre-1947 rental dwellings, though excluding future construction, may, rather ironically, contribute in more than one way to relatively high rents which will be demanded on future dwellings. Such a develop-

ment may occur for the reason that landlords will now be convinced, more than ever before, that with time there will eventually be successful pressure for new rent legislation to cover future construction. The fear of additional legislation which will severely curtail chances for capital gains on these newly built properties, may therefore prompt a demand for as high a current return as possible, through the medium of high rents. The question of a "proper return" is thus shown to be inextricably tied with that of owners' expectations: the higher the expectations, the lower will be the current acceptable return and vice versa.

What are these expectations at present? Sternlieb has very bleakly concluded that "among owners [of rent controlled properties] there is a pervasive crisis of confidence in the future."[15] The effect of this pessimistic outlook has been aptly stated by Rand: "an upward shift in the market rate of return on invested capital (yields that would have been acceptable twenty years ago are submarginal today)."[16] This development seems to be in line with a long-run "tendency for capitalization rates for real estate to rise",[17] as pointed out by Grebler, Blank and Winnick who attributed the early noticeable stage of this trend to "the collapse of real estate values after 1929."[18] Winnick has similarly concluded that:

> So far as the equity investor is concerned, the attractiveness of new rental housing as a medium of investment has obviously diminished over the

> last generation. The result has been not only a decrease in the volume of available equity capital but also an increase in the rate of return at which venture capital can be attracted; these rates have been apparently much higher in the post-war era than they were before 1929.[19]

The answers solicited by our own questionnaire (mentioned earlier in this chapter) evoke, rather disturbingly, a similar mood of a low degree of confidence among investors, even among those who have invested in non-rent controlled rental housing in New York City.[20] A reasonable assurance of a sufficient return on investment may thus hold the key to renewed private construction of multi-family rental housing in the City.[21]

B. Property Returns 1964-1968

1. Definition. Of the various measures of real estate investment performance, the so-called "property return"[22] is probably the best suited yardstick,[23] if a comparative analysis with investment experience of other properties is to be undertaken. In essence, such measurement--whatever the term used[24]--calculates: "the net return on a 'free and clear' basis, i.e., the percentage of the acquisition cost of the real estate accounted for by the difference between gross income and out-of-pocket operating costs."[25] In other words, this yardstick employs a fraction in the following form:

$$\frac{\text{(Revenues-Operating Expenses)} \times 100}{\text{Cost of Property}}$$

The use of the particular denominator in the above fraction

may subject the property return yardstick to the criticism that it does not relate income to any current estimate of value, but ties such present income to a historical cost figure. This shortcoming--which arises when use is made of financial statements in general, and the balance sheet in particular--will be considered later in this chapter when assessed valuation of properties will be resorted to, rather than historical costs. The above numerator, on the other hand, is based on the widely accepted concept of a "free and clear income," one which--by virtue of excluding depreciation, debt service charges, and federal income taxes--"is independent of any particular ratio of debt to equity or other mortgage terms,"[26] and is independent as well, of any specific tax strategy of cost allocation via depreciation charges. It is for these reasons that Winnick has considered this yardstick to be "the single best measure of the inherent earning capacity of the property."[27]

The exclusion of the depreciation expense from operating expenses in the numerator of the formula mentioned above, is accompanied by a corresponding exclusion of accumulated depreciation from the cost of property in the denominator. We are thus provided with a measure of return that is not dependent on depreciation book entries, hence allowing for comparison with returns on other investments where depreciation is not customarily claimed (investment in securities, unimproved real estate, etc.). The advantages in-

herent in a measure of return that excludes depreciation charges as well as income taxes and finance outlays were pointed out recently by Sternlieb:

> Because of differences in the taking of depreciation allowances, and variations in the value of depreciation as a function of the landlord's overall tax rate, more adequate measures of the output of a realty investment are contribution to debt, depreciation, and profit and/or cash flow. Cash flow, in turn, is subject to variations in financing strategy, leaving contribution to debt, depreciation and profit as the only really comparable operational figure.[28]

The bulk of the analysis in this chapter is based indeed on the property return yardstick. It should also be noted that an analysis such as the present one, emphasizes the investment return qualities inherent in the property, rather than the specific proprietorship associated with it. Because of this emphasis, and in order to allow for comparison between different properties--disregarding changes in ownership that may have taken place during the period under review, 1964-1968--the cost of the property was assumed to have been the one on the books as of the end of 1964 (unless construction was concluded at a later date, in which case the cost shown on the books,as of the date of completion of construction,was used). Where capitalized improvements of a property occured during any of the years, 1965-1968, thereby increasing the cost of the property on the books: such change of cost was reflected in our computations through an averaging adjustment which

added one-half of the increase to the cost of the property in the year in which the addition took place, while adding the full amount of the increase in subsequent years.

2. Findings. Several findings of interest emerge from an examination of Table 5-1. It appears that New York City FHA Section 207 sample properties yielded an annual return in the range of six to seven per cent during the five-year span, 1964-1968. Furthermore, two clearly separate periods can be distinguished: an early one (1964-1967) and a later period (1968). During the first four years a "softness" of return rates will be noted; they are quite probably below 6.50 and moreover, their movement from year to year is erratic, so that 1966 average rates were probably lower than those of 1964. In the last year we witness a definite improvement: rates have clearly exceeded the 6.5 per cent mark, approximating in fact, 7.00 per cent.

The trends manifested in Table 5-1 should not come as a surprise: the earlier part of the period under review witnessed voluminous residential construction activity in New York City; but such activity dwindled considerably in the mid-and late 1960's. It would thus appear that the above mentioned "softness" in rates, understandably accompanied the easing of the housing shortage in the early 1960's and the emergence more or less of a "tenants' market," while the subsequent shrinkage of the rental housing supply, which eliminated many competitive features from the rental

TABLE 5-1

FHA SECTION 207 NEW YORK CITY SAMPLE--PROPERTY RETURNS 1964-1968

Average and Confidence Limits	1964	1965	1966	1967	1968
Arithmetic mean of sample-----	6.30%	6.17%	6.22%	6.43%	6.96%
Confidence limits for the population mean:					
At 50% confidence probability.....	6.18-6.42	6.06-6.28	6.13-6.31	6.33-6.53	6.86-7.06
At 80% confidence probability.....	6.07-6.53	5.96-6.38	6.04-6.40	6.25-6.61	6.76-7.16

Source: FHA Section 207 New York City sample

housing market, made for increases in property return rates. Considering the fact that expiration dates of any number of leases are normally staggered over a number of years, it will also become clear why the increase in property rates of return lagged behind the decline in construction activity; the latter having first been noticed as early as 1963 and 1964, while material increases in property rates of return took place several years later, with the impact being fully felt by 1968.[30]

3. Comparison with bond yields and interest rates on mortgage commitments. How sufficient was the property return on New York City FHA Section 207 rental properties during the period 1964-1968? One acceptable means by which sufficiency could be evaluated is a comparison of property rates of return with yields on bonds.[31] Although there are essential differences between the two types of investment,[32] a comparison is possible in the following manner: assuming that such differences in investment quality have been manifested over a number of years in a "gap"--or a "spread"--between the rates of return required by investors in residential real estate, versus those desired by investors in financial instruments (bonds, etc.), our task then is to examine changes in the spread during the five-year period, 1964-1968.

The picture that emerges from Table 5-2 is not a bright one in regard to property returns during the period 1964-1968.

TABLE 5-2

FHA SECTION 207 NEW YORK CITY SAMPLE--PROPERTY RETURNS VS. BOND YIELDS
1964-1968

	1964	1965	1966	1967	1968
Property Returns: Arithmetic mean of sample--------	6.30%	6.17%	6.22%	6.43%	6.96%
Confidence limits for the population mean:					
At 50% confidence probability.....	6.18-6.42	6.06-6.28	6.13-5.31	6.33-6.53	6.86-7.06
At 80% confidence probability.....	6.07-6.53	5.96-6.38	6.04-6.40	6.25-6.61	6.76-7.16
Yields on U.S. long-term bonds	4.15	4.21	4.66	4.85	5.25
Yields on Corporate bonds (Moody's Investors Service series)	4.57	4.64	5.34	5.82	6.51
Yields on Aaa Corporate bonds (Moody's Investors Service series)	4.40	4.49	5.13	5.51	6.18

TABLE 5-2
(cont'd)-2

	1964	1965	1966	1967	1968
Spread between property returns and yields on U.S. long-term bonds:					
Arithmetic mean of sample----------	2.15	1.96	1.56	1.58	1.71
Confidence limits for the population mean:					
At 50% confidence probability.....	2.03-2.27	1.85-2.07	1.47-1.65	1.48-1.68	1.61-1.81
At 80% confidence probability.....	1.92-2.38	1.75-2.17	1.38-1.74	1.40-1.76	1.51-1.91
Spread between property returns and yields on corporate bonds:					
Arithmetic mean of sample----------	1.73	1.53	.88	.61	.45
Confidence limits for the population mean:					
At 50% confidence probability.....	1.61-1.85	1.42-1.64	.79-.97	.51-.71	.35-.55
At 80% confidence probability.....	1.50-1.96	1.32-1.74	.70-1.06	.43-.79	.25-.65

TABLE 5-2
(cont'd)-3

	1964	1965	1966	1967	1968
Spread between property returns and yields on Aaa corporate bonds:					
Arithmetic mean of sample----------	1.90	1.68	1.09	.92	.78
Confidence limits for the population mean:					
At 50% confidence probability.....	1.78-2.02	1.57-1.79	1.00-1.18	.82-1.02	.68-.88
At 80% confidence probability.....	1.67-2.13	1.47-1.89	.91-1.27	.74-1.10	.58-.98

Sources: Property returns-Table 5-1
Yields on bonds--Federal Reserve Bulletin December 1969, p.A34.

Observing the movement of the sample arithmetic mean of property returns, it becomes clear that in spite of the improvement in property returns in 1968, the spread between the returns on investment in FHA Section 207 New York City sample properties and the yields on corporate bonds narrowed throughout the period 1964-1968. Starting with 1.73 per cent in 1964, the spread was reduced to approximately a quarter of that size and almost disappeared in 1968 (.45 per cent). The spread between the property returns and the yields on highest-quality corporate bonds rated Aaa, also diminished consistently: from an original amount of 1.90 per cent in 1964, it was reduced to less than half by 1968 (.78 per cent). A somewhat improved performance of property returns is noted during the last two years, 1967 and 1968, when a comparison is made with yields on United States long-term bonds; during these two years the spread increased, equalling 1.71 per cent in 1968, above the low point of 1.56 per cent registered in 1966. The 1968 figure is, however, well below the amounts noted in the early years of 1964 and 1965: 2.15 per cent and 1.96 per cent respectively. Setting up confidence limits for the population mean of property returns, we still observe a definite and substantial narrowing of spread between property returns and yields on bonds for the priod under consideration.

It thus becomes clear that the so-called improvement in property returns at the end of the period <u>was actually</u>

an attempt to maintain parity with return on other investments, and it furthermore appears that this attempt failed, when comparison is made with yields on corporate bonds (including a separate comparison with yields on high-grade corporate bonds). It will also be noted that property returns exhibited a much greater volatility than bond yields: while the latter--be they United States or corporate--consistently rose every year during the period 1964-1968, the former did not. Exhibiting no consistent change in the early years, property returns definitely rose, for the first time during this period, in 1968. In the face of a narrowing spread and a substantial risk due to volatility, it must be concluded that the desirability and attractiveness of investment in New York City non-rent-controlled multi-family rental housing, as represented by FHA Section 207 properties, diminished during the period 1964-1968. It appears also that many of the widely publicized "rent gouging" cases of 1968 may have in reality been an attempt to improve a chronically faltering spread between property returns and bond yields.[33] (For reports on alleged "rent gouging" by owners of FHA Section 207 properties, see Chapter I, note 50.)

These conclusions are reinforced by Table 5-3 which provides a comparison between FHA Section 207 New York City sample property returns and average interest rates on certain mortgage commitments. (The use of confidence limits

TABLE 5-3

FHA SECTION 207 NEW YORK CITY SAMPLE PROPERTY RETURNS VS AVERAGE INTEREST RATES ON MORTGAGE COMMITMENTS ON MULTI-FAMILY AND NON-RESIDENTIAL PROPERTIES REPORTED BY 15 LIFE INSURANCE COMPANIES 1965 (PARTIAL YEAR) - 1968

	1965	1966	1967	1968
Average interest rates on mortgages--total	5.99%	6.35%	6.92%	7.65%
Property returns - arithmetic mean of sample.....	6.17	6.22	6.43	6.96
Average interest rates on mortgages-conventional apartments.....	6.07	6.44	7.01	7.75
Spread between property returns-arithmetic mean of sample and average interest rates on mortgages-total.....	.18	(.13)	(.49(	(.69)
Spread between property returns-arithmetic mean of sample and average interest rates on mortgages-conventional apartments....	.10	(.22)	(.58)	(.79)

Sources: Property returns-Table 5-1
Average interest rates on mortgage commitments-American Life Convention and Life Insurance Association of America, Joint Investment Bulletin. Data was extracted from Tables A and U of bulletin No. 562, July 13, 1966 and from Table 1 of bulletin No. 636, June 15, 1969[34]

for the FHA Section 207 population mean--as indicated in Tables 5-1 and 5-2--would not have changed the results materially.) As Table 5-3 shows, the mortgages which (like bonds) are debt obligations, have consistently commanded a higher interest rate from one year to the next, throughout the period 1965-1968. In 1965 the spread was still in favor of the property returns, but its algebraic sign subsequently changed, turning in favor of mortgages of all kinds, with the differential increasing continuously from one year to the next. It would thus appear that--forsaking income tax considerations which will be considered later in this chapter--New York City non-rent-controlled multi-family rental housing, as represented by FHA Section 207 buildings, provided property returns which were lower than certain mortgage yields during the period, 1966-1968. Admittedly this is a comparison between FHA Section 207 properties in New York City on one hand, and mortgages on improved real estate all over the United States and Canada on the other; but the comparison is valid nevertheless, since mortgage ownership, unlike many cases of equity proprietorship of rental housing, does not usually require any managerial efforts on the part of the owner. The prospective investor does, therefore, possess the choice between property ownership of rental housing in New York City, and the acquisition of a mortgage portfolio representing locations other than New York City as well. Under the condi-

tions portrayed in Table 5-3, he will probably opt for the latter. Furthermore, the New York City equity owner who has mortgaged his rental property at the relatively high interest rates (per Table 5-3)--once again ignoring income tax considerations--will suffer from the effects of "leverage in reverse," reaping for himself a much lower return, in order to provide mortgage interest payment at a rate which is higher than that yielded by his own property on a free and clear basis. Since such a state of affairs is unacceptable to the reasonable mortgagor, the conclusion is inescapable that whoever built a rental property during the period under review, was obliged to charge higher and higher rents; one of the reasons being the ever growing interest rates on new mortgage commitments. Owners of existing properties whose turn came to refinance their mortgages, must have been faced with a similar problem--such as may provide an additional explanation for the "rent gouging" phenomenon of 1968 (as mentioned earlier).

An historical perspective which should allow for a more meaningful evaluation of recent returns is provided in Table 5-4. Comparing it with Table 5-2, we find that the FHA Section 207 property returns in the period 1964-1968, approximated those yielded by the FHA Section 608 properties in the years 1951-1956. In both cases rates moved somewhat erratically between 6 and 7 per cent, and it was no earlier than 1968 that the rate exceeded those posted for

TABLE 5-4

CERTAIN PROPERTY RETURNS IN NEW YORK CITY VS BOND YIELDS FOR SELECTED YEARS DURING THE PERIOD 1925 - 1956

Year	Property Return	Yield on U.S. Long-Term Bond	Yield on Aaa Corporate Bonds (Moody's Investor Service Series)	Spread between Property Return and Yield on U.S. Long-Term Bonds	Spread between Property Return and Yield on Aaa Corporate Bonds
1925	8.48	3.86	4.88	4.62	3.60
1930	7.72	3.29	4.559	4.43	3.17
1935	2.48	2.79	3.60	(.31)	(1.12)
1940	2.85	2.26	2.84	.59	.01
1945	3.06	2.37	2.62	.69	.44
1951	6.90	2.57	2.86	4.33	4.04
1952	6.80	2.68	2.96	4.12	3.84
1953	6.72	2.94	3.20	3.78	3.52
1954	6.27	2.55	2.90	3.72	3.37
1955	6.34	2.84	3.06	3.50	3.28
1956	6.51	3.08	3.36	3.43	3.15

Sources: Property returns 1925-1950-elevator apartment houses, Leo Grebler, Experience in Urban Real Estate Investment, op. cit., pp. 265-266 (rates above are arithmetic averages of rates for two classes shown by Grebler)

TABLE 5-4
(cont'd.)

Sources: Property Returns 1951-1956-FHA 608 rental projects New York elevators, Winnick, Rental Housing: Opportunities for Private Investment, op. cit., p. 281 (computation of rates above was based on data presented by Winnick). Bond Yields-U.S. Bureau of the Census, Historical Statistics of the United States Colonial Times to 1957, Washington, D.C. 1960, p. 656

the years 1951-1953. Property returns on the whole were rather stationary during the two period which, when put together, span almost two decades, the 1950's and the 1960's. While these rates clearly exceed the extremely meager ones which were posted by older elevator apartment houses during the depression and war years (see returns for 1935, 1940 and 1945 in Table 5-4), they failed, however, to reach the high levels established during the real estate boom of the 1920's--so far, the latter returns have never since been matched. On the other hand, bond yields--both U.S. and Aaa corporate--have risen rather consistently and continuously through the years (with the exception of the depression and war years) so that by 1968 they were clearly above their pre-depression level of 1925. As a result of stagnating property returns on one hand, and rising bond yields on the other, we have been encountering ever-narrowing spreads between property returns and bond yields, which by 1968 reached one of their lowest levels, comparable only to the extremely narrow spreads of the depression and the war years. This analysis points up a long-run history of lessening attractiveness of investment in New York City rental properties as compared to investment in bonds, a process which continued during the period 1964-1968. (excepting investments in U.S. bonds where the possibility of a slight increase in spread was noted for the years 1967 and 1968). Winnick termed the operating returns of the 1950's (as shown in Table 5-4) "far from good,"[35] and

this at a time when the spread between property returns and the yield on United States long-term bonds ranged from a high of 4.33 per cent to a low of 3.43 per cent, while the spread between the same property returns and the yield on Aaa corporate bonds varied from a peak of 4.04 per cent to a low point of 3.15 per cent (Table 5-4). In the 1960's the corresponding spreads were halved (or cut to even less than half) ranging from a high of slightly over 2 per cent to a low of approximately 1.50 per cent and from a high of around 2 per cent to a low of well below 1 per cent respectively (Table 5-2). With such minimally thin spreads during much of the 1960's returns must be concluded to have moved not "closer to good," (to paraphrase Winnick), but further away from it.

4. Comparison with property returns outside New York City. There are several indications that the New York City property returns also consistently fared rather poorly compared to returns on residential rental properties situated in other areas in the United States. Case, who studied Los Angeles real estate,[36] has observed a relatively superior investment experience on the West Coast, despite the overall long-run moderation of those returns. As shown (in Table 5-5) Los Angeles property returns have consistently risen, exceeding the New York City returns (Table 5-4) by a wide margin; such margin amounting, most of the time,to approximately 7 percentage points. A nar-

TABLE 5-5

AVERAGE NET INCOME ON CERTAIN LOS ANGELES RESIDENTIAL RENTAL PROPERTIES EXPRESSED AS A PERCENTAGE OF ORIGINAL ACQUISITION COST CLASSIFIED BY HALF-DECADES, 1935-1945

Earning Periods by Half-Decade	Net Income as a Percentage of Purchase Price
1935-39	9.7%
1940-44	10.1
1945-49	11.1
1950-54	13.3
Average all periods	11.0

Source: Case, ibid., p. 47

sower margin, but one which has nevertheless become quite substantial in the mid-1950's, is derived from a comparison of returns on certain Chicago properties (Table 5-6), with the New York City returns (Table 5-4). The margin seems to have exceeded 6 percentage points both in 1955 and in 1956 in favor of the Chicago buildings. Winnick understandably concluded "that the investment performance of rental property in Chicago has been relatively better than in New York City."[37] It would thus appear that ever since the depression years, investment in New York City rental housing has suffered from a noticeable disadvantage of relatively low returns; both when compared with yields on bonds and in comparison with property returns in several other American cities. Such a relative disadvantage, if persistent in the long-run, is bound to discourage massive investment of private capital in New York City rental housing.

It should be noted at this point that an investor may still be attracted to real estate property,despite a narrowing spread between property returns and bond yields, in the expectation of sizable capital gain prospects (which are not included in the computation of property returns), upon sale and liquidation of his investment in the property. It is not too often, however, that a material capital gain--which after all, results from an improvement in the earning capacity of the asset--will materialize in the face of consistently low property returns, resulting in a declining

TABLE 5-6

NET INCOME ON 18 CHICAGO APARTMENT PROPERTIES EXPRESSED AS A PERCENTAGE OF ORIGINAL INVESTMENT FOR SELECTED YEARS DURING THE PERIOD 1936-1956

Year	Net Income as a Per Cent of Original Investment
1936	3.5%
1940	5.1
1945	6.2
1951	6.7
1952	7.4
1953	7.9
1954	9.6
1955	12.9
1956	12.7

Source: Winnick, Rental Housing: Opportunities for Private Investment, op. cit., p. 267. According to Winnick the record of these "properties appears to be typical for Chicago for the span of years covered." (It should be noted however, that the usefulness of the sample is limited because of its very small size.)

spread between property returns and bond yields.

5. Property return on assessed valuation. A property return analysis will not be complete without some measurement which relates operating income to current market values. As pointed out by James, "yield on any investment is significant only as related to current value of the investment."[38] A handy approximation of such market values is provided by local assessment rolls, as adjusted by the state equalization rates.[39]

The frequent use of assessed valuations as a criterion of property yield, by both governmental and private authorities, attests to its wide acceptablility. Most recently it has been incorporated into a New York City law, which provides for gradual rent increases in rent-controlled properties, allowing the landlord a return of 8.5 per cent of equalized assessed valuation.[40] Average returns on equalized assessed valuation of FHA Section 207 New York City sample properties--such equalized assessed valuation being the best approximation of market values available on a universal basis[41]--approximated 6 and 7 per cent in 1964 and 1968 respectively (Table 5-7).

A comparison of these data (Table 5-7) with Table 5-1 is of interest: it indicates that while property returns based on cost (Table 5-1) have increased from 1964 to 1968 by approximately one-half of a percentage point (from a low 6 per cent to high 6 per cent), returns on equalized assessed valuation (Table 5-7) have risen by

TABLE 5-7

FHA SECTION 207 NEW YORK CITY SAMPLE-RETURNS ON ASSESSED VALUE, 1964 AND 1968
(OPERATING INCOME AS A PERCENT OF ASSESSED VALUE)

Average and Confidence Limits	1964	1968
Return on assessed valuation:		
Arithmetic mean of sample.....	8.30%	9.65%
Confidence limits for the population mean:		
At 50% confidence probability.....8.12-8.48		9.47-9.83
At 80% confidence probability.....7.95-8.65		9.31-9.99
Return on equalized assessed valuation:		
Arithmetic mean of sample.....	5.87	6.88
Confidence limits for the population mean:		
At 50% confidence probability.....5.72-6.02		6.71-7.05
At 80% confidence probability.....5.59-6.15		6.55-7.21

Source: FHA Section 207 New York City sample

1 percentage point (from 6 per cent to 7 per cent). As a result, the spread between the traditionally higher returns based on cost, and the somewhat lower returns based on approximation of market values, has tended to narrow during the period 1964-1968, or, at best, remain stationary. The probability of a relatively wide spread in 1964 meant that current market prices were substantially higher than the original costs of those properties--a sign of high expectations on the part of prospective buyers, which, in turn, provide sellers with capital gains. By 1968, however, expectations must have diminished, for current market prices apparently no longer exceeded original property costs substantially, and opportunities for capital gains were cut. This interesting development lends support to our earlier finding in regard to the relatively low rise in property returns during the period; a rise which fell short compared with changes in yields on bonds. The lesson is therefore clear: when returns do not match earlier expectations a market reaction is certain to follow; further substantial increases in property prices will be arrested, if not reversed.[42]

The effects of an insufficient return are pervasive indeed, and not the least among them is the changing attitude of the landlord toward his property; with hopes for long-term capital gain all but vanished, he now tends to treat his investment as short-term one, searching for all avail-

able means to enhance the return on his own equity, which was supposed to be carved out of what proved to be a faltering property return. Financing terms and conditions assume a critical importance in this situation, and tax considerations come to the forefront; since the only possible justification that could be attributed to an investment in a property that fails to generate a sufficient return of its own; is the tax-shelter that it may provide for one's other income, thus minimizing one's overall tax burden, and increasing effective net return (after taxes) on total investment (as will be shown in this chapter).

6. Cross-sectional analysis. The cross-sectional tabulation of property returns (provided in Table 5-8) is a valuable addition to the overall data of Table 5-1. The tabulation confirms our earlier finding regarding the superior performance record of the Manhattan properties in relation to the others. This superiority is manifested in property returns which--when measured by the arithmetic mean of the sample--tended to exceed those generated by dwelling in the other boroughs, be they high-risers or six-story structures, during each of the five years under review. In the later years, however, beginning with 1966, and especially in 1967 and 1968, the margin of Manhattan's superior performance over the other boroughs widened significantly, and without doubt, at all statistical confidence levels. Thus, assuming the lowest point

TABLE 5-8

FHA SECTION 207 NEW YORK CITY SAMPLE--A CROSS-SECTIONAL TABULATION OF PROPERTY RETURNS, 1964-1968

Average and Confidence Limits	Manhattan	Other Boroughs		Total: All Boroughs,
	All Highrisers	Highrisers	Six-Stories	Six-Stories & Highrisers
1964:				
Arithmetic mean of sample------	6.48%	5.76%	6.47%	6.30%
Confidence limits for the population mean:				
At 50% confidence probability....	6.22-6.74	5.48-6.04	6.32-6.62	6.18-6.42
At 80% confidence probability.....	5.98-6.98	5.23-6.29	6.17-6.77	6.07-6.53
1965:				
Arithmetic mean of sample--------	.6.32	5.84	6.25	6.17
Confidence limits for the population mean:				
At 50% confidence probability.....	6.16-6.48	5.60-6.08	6.09-6.41	6.06-6.28
At 80% confidence probability.....	6.02-6.62	5.39-6.29	5.94-6.56	5.96-6.38

TABLE 5-8
(cont'd.)-2

Average and Confidence Limits	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total: All Boroughs, Six-Stories & Highrisers
1966:				
Arithmetic mean of sample------	6.67	5.57	6.24	6.22
Confidence limits for the population mean:				
At 50% confidence probability....	6.52-6.82	5.36-5.78	6.12-6.36	6.13-6.31
At 80% confidence probability....	6.38-6.96	5.17-5.97	6.00-6.48	6.04-6.40
1967:				
Arithmetic mean of sample-------	7.27	5.74	6.15	6.43
Confidence limits for the population mean:				
At 50% confidence probability....	7.13-7.41	5.53-5.95	6.02-6.28	6.33-6.53
At 80% confidence probability....	7.00-7.54	5.34-6.14	5.90-6.40	6.25-6.61

TABLE 5-8
(cont'd.)-3

Average and Confidence Limits	Manhattan All Highrisers	Other Boroughs Highrisers	Other Boroughs Six-Stories	Total: All Boroughs, Six-Stories & Highrisers
1968:				
Arithmetic mean of sample------	7.84	6.17	6.66	6.96
Confidence limits for the population mean:				
At 50% confidence probability.....	7.66-8.02	5.90-6.44	6.56-6.76	.6.86-7.06
At 80% confidence probability.....	7.50-8.18	5.65-6.69	6.47-6.85	6.76-7.16

Source: FHA Section 207 New York City sample

on the 1968 range for the Manhattan population mean at an 80 per cent confidence probability level, we find (Table 5-8) a property return of 7.50 per cent, well above the highest point on the corresponding range for the next "best performer," the six-story population: 6.85 per cent.

The better performance of Manhattan properties resulted from the fact that this sector was the first to recover from the "sluggishness" of the rental market aroung 1965, following the sizable construction of residential dwellings in New York City in the early 1960's. The recovery in Manhattan was such (Table 5-8) that average returns in 1967 clearly exceeded those of 1964, while in the other boroughs there was no such unequivocal recapture of the old level even by 1968. It thus appears that the growing housing shortage in the City, and the great desirability of a Manhattan location, are reflected in the returns earned by Manhattan properties; and while these returns are by no means exorbitant, their clear-cut rise, especially since 1967, is indicative of underlying powerful market forces (great demand versus a limited supply).

The picture presented in the other boroughs is much more mixed. Using either the arithmetic mean of the sample, or a 50 per cent confidence probability level (Table 5-8), we find the six-story structures consistently performing better than the highrisers throughout the years under review. The highrisers of the other boroughs

emerge as the "poorest performers" for the period among all of the three sectors. This finding lends support to our earlier observation regarding the effect of market forces on rent levels and rates of return: demand for highrisers in other boroughs, though increasing during the years--due to the general shortage of rental housing in New York City--has apparently not been as strong as that for other rental dwellings (witness the slower decline in vacancy losses for other boroughs' highrisers, per Table 2-11); as a result their returns have constantly lagged behind returns on six-story apartment buildings in the other boroughs and highrisers in Manhattan.

C. Returns on Equity 1964-1968

1. Limitations and method of analysis. While property returns (if available) are readily given to instant and universal comparison since they are not shaped by a particular depreciation policy or a specific financing mix, computed as they are on a "free and clear basis," returns on equity--in contrast--are highly dependent upon such factors as depreciation deductions for tax purposes and methods of financing. A given property return, for example, may yield twice as high an equity return for a given year, if debt capital was secured at a relatively low cost and/or

if sufficient "tax shelter" was provided by a sizable depreciation deduction. It is for these reasons, that any findings regarding return on equity should be evaluated with full recognition of the specific and narrow context of financing policies applicable to them; in the case of FHA Section 207 properties, it would mean an original maximal 90 per cent debt financing through mortgage, and an original 10 per cent equity financing.[43] With all its limitations, a study of equity returns should prove valuable nevertheless, for it will demonstrate the effect of certain policies in converting a given property return to a return on equity. Allowances may then be made in order to gauge the effect that a different set of conditions (such as a higher or lower debt financing at a higher or lower interest rate) will have on the equity return which is to be "carved out" of the overall property return. In addition, any contribution to the methodology of rental housing equity return analysis, and to the bank of data available at the present time, will be welcomed because of the scarcity of current information on the subject.[44]

By computing returns prior to, and subsequently to a consideration of the "tax shelter" provided by the depreciation deduction, the following analysis separately measures the effect of "leverage" or "trading on the equity" (financing through debt),and that of depreciation.

Three alternative tax rates are provided: 30, 50 and 70 per cent; thus allowing for both modest and high-income unincorporated investors, as well as corporate equity investors. Since this is an analysis of equity returns, rather than of net cash flow to the investor, only the interest element of the total debt servicing has been included in expenses, excluding amortization of the mortgage principal.[45] The following formula represents the approach used here:

$$\text{Equity Return} = \left[\frac{\text{Revenues-Expenses}^{*}}{\text{Original Equity Investment}^{**}}\right] \times 100$$

*Operating expenses, excluding depreciation, plus interest, before and after tax effect of depreciation.
** Cost of property less original mortgage principal.

While the formula enables us to measure the effect of the depreciation deduction through income tax savings, depreciation itself is excluded as an operating expense from the numerator, with a corresponding exclusion of accumulated depreciation, from the denominator. As explained earlier in this chapter (Section B, Property Returns, 1964-1968), this method allows for comparison with returns on other investments where depreciation is not customarily claimed (e.g. investment in securities, unimproved real estate, etc.) For further clarification, see note 28 in this chapter, regarding the limitations which are involved in the exclusion of depreciation from this analysis.

With the limitations of an equity return analysis having readily been acknowledged, no confidence limits for the population means were set-up in the following analysis. The findings are restricted, therefore, to the sample, unlike the earlier findings regarding the all-important property returns which are applicable to the entire FHA Section 207 New York City population, as indicated by the two confidence probability levels used in our analysis.

2. Tax shelter effect of leverage and depreciation. Certain conclusions emerge from Table 5-9: first, it will be noticed that equity returns over the period 1964-1968, have traced the same general "down and up" trend drawn by property returns (as indicated in Table 5-1). In this respect the absence or presence of debt financing did not cause any material change. Second, equity returns, in any one of the five years, grow progressively smaller with higher tax rates. Such a situation means that in the absence of a sizable deduction for depreciation, taxable income would have been positive, thus requiring actual tax payments and making investment in rental housing much less attractive to investors in relatively high tax brackets, when compared with alternative investments in say, non-taxable municipal bonds. Third, as demonstrated (in Table 5-11; a comparison between equity returns, Table 5-9, and property returns after income taxes, Table 5-10); the effect of leverage was very signifi-

TABLE 5-9

FHA SECTION 207 NEW YORK CITY SAMPLE-EQUITY RETURNS AT DIFFERENT TAX LEVELS, EXCLUDING CONSIDERATION OF TAX SHELTER PROVIDED BY DEPRECIATION DEDUCTION, 1964-1968 (ARITHMETIC MEAN OF SAMPLE)

Assumed Income Tax Rate	Equity Returns				
	1964	1965	1966	1967	1968
30%	8.22%	7.04%	8.25%	9.84%	14.19%
50%	5.87	5.03	5.89	7.03	10.14
70%	3.52	3.02	3.53	4.21	6.08

Source: FHA Section 207 NYC sample

TABLE 5-10

FHA SECTION 207 NYC SAMPLE-PROPERTY RETURNS AT DIFFERENT TAX LEVELS 1964-1968 (ARITHMETIC MEAN OF SAMPLE)

Assumed Income Tax Rates	Property Returns				
	1964	1965	1966	1967	1968
30%	4.41%	4.32%	4.35%	4.50%	4.87%
50%	3.15	3.09	3.11	3.22	3.48
70%	1.89	1.85	1.87	1.93	2.09

Source: FHA Section 207 NYC sample.

TABLE 5-11

FHA SECTION 207 NEW YORK SAMPLE-DIFFERENCES BETWEEN EQUITY RETURNS AND PROPERTY RETURNS AT DIFFERENT TAX LEVELS 1964-1968 (ARITHMETIC MEAN OF SAMPLE)

Assumed Income Tax Rates	Excess of Equity Returns over Property Returns				
	1964	1965	1966	1967	1968
30%	3.81%	2.72%	3.90%	5.34%	9.32%
50%	2.72	1.94	2.78	3.81	6.66
70%	1.63	1.17	1.66	2.28	3.99

Source: FHA Section 207 sample

TABLE 5-12

FHA SECTION 207 NEW YORK CITY SAMPLE-EQUITY RETURNS AT DIFFERENT TAX LEVELS, INCLUDING CONSIDERATION OF TAX SHELTER PROVIDED BY DEPRECIATION DEDUCTION, 1964-1968 (ARITHMETIC MEAN OF SAMPLE)

Assumed Income Tax Rate	Equity Returns				
	1964	1965	1966	1967	1968
30%	17.26%	16.15%	17.33%	18.99%	23.33%
50%	20.94	20.21	21.03	22.28	25.32
70%	24.62	24.27	24.73	25.56	27.31

Source: FHA Section 207 New York City sample

cant indeed: it endowed the equity investor with a return which, in the last two years under consideration, was approximately double and even triple the rate available to him under no debt financing (property return). The attractiveness of fixed interest financing at a relatively low cost, under conditions of rising property returns--a situation that allows the growth in the operating profit "pie" to be shared exclusively by the equity investor--becomes eminently clear.

The crucial role played in equity returns by the depreciation deduction for income tax purposes is demonstrated in Tables 5-12 and 5-13. The assumption underlying these two tables is,that taxable losses (which are produced through the depreciation deduction) are used to offset income available to the equity investor from other sources--in other words, the depreciation deduction is used first to "shelter" income generated by the rental property from taxation and, to the extent that this deduction exceeds such income, it is used to similarly "shelter" other income accruing to the investor: the deduction is thus assumed to have a definite monetary value in all cases.[46]

Tables 5-12 and 5-13 reflect the great value of the depreciation deduction for the equity investor in rental housing; this deduction turns an otherwise, relatively meager return (Table 5-9) into a much more substantial one (Table 5-12). Moreover, by providing a tax shelter which grows in size as a taxpayer's income and

TABLE 5-13

FHA SECTION 207 NEW YORK CITY SAMPLE-VALUE OF TAX SHELTER: DIFFERENCES BETWEEN EQUITY RETURNS, BEFORE AND AFTER DEPRECIATION DEDUCTION, AT DIFFERENT TAX LEVELS, 1964-1968 (ARITHMETIC MEAN OF SAMPLE).

Assumed Income Tax Rate	Value of Tax Shelter				
	1964	1965	1966	1967	1968
30%	9.04%	9.11%	9.08%	9.15%	9.14%
50%	15.07	15.18	15.14	15.25	15.18
70%	21.10	21.25	21.20	21.35	21.23

Source: FHA Section 207 New York City sample

corresponding tax rate increase, the deduction proved to be much more valuable to the higher income investor. We thus find (from Table 5-13) that while the tax shelter slightly exceeded 9 per cent for the taxpayer at the 30 per cent bracket, it slightly exceeded 15 per cent at a 50 per cent tax rate, and was well above 21 per cent at the 70 per cent tax bracket. It will also be noticed that the tax shelter was provided consistently at an approximately fixed given size (be it 9, 15 or 21 per cent), for each tax rate throughout the period 1964-1968.

Our analysis has thus shown the substantial effect of proper leverage on the one hand, and the depreciation deduction on the other. The two have combined to raise property returns after taxes from the 4, 3 and 2 per cent levels (Table 5-10) to equity return levels ranging from 16 to 27 per cent (Table 5-12). This finding is in line with conclusions arrived at by other sources: Palmerio, who studied the records of ten New York City rent-controlled buildings, observed that firstly, "higher tax rates produced large tax savings and consequently higher equity returns"[47] and secondly, the "highest rates of return after taxes and before revenue increases were derived by landlords having the least amount of equity in the sturcture."[48] The relation between property and equity returns was summarized by Palmerio as follows: "although the property return rate was rather low for all of the 10 buildings, equity return after taxes was

significantly higher for those structures with small equity investments, relatively high depreciation expenses and substantial Federal income tax credits."[49]

The importance of judicious use of leverage has been recently emphasized by Sternlieb who, in discussing the refinancing difficulties faced by owners of rent-controlled properties, due to the attitudes of institutional lenders, stated that "most of the return on residential real estate comes not from the operations of the building per se, but from the capacity of the owner to remorggage his building."[50] Wendt and Wong have also recently drawn attention to the importance of leverage as a factor in equity return on investment in real estate: "the ability to trade on equity in real estate accounts in substantial measure for the margin of difference of real estate over stock after-tax yields, and the interest on debt capital is a key determinant in real estate investment profitability."[51] They further suggested that "an investor contemplating alternative investments in real estate versus common stocks today should, in endeavoring to forecast relative ex ante yields, focus primary attention upon the prospects for changes in real estate investment tax shelter, and with respect to common stocks, upon the prospects for capital gains."[52] Earlier mention of the crucial role played by proper leverage was made by Winnick, who observed in the mid-1950's that equity investors in real estate required

"a minimum [return] of 15 to 20 per cent per year from new buildings,"[53] and that these returns "are more readily achievable if a very high proportion of cheap long-term debt capital can be obtained."[54]

3. Cross-sectional analysis. A cross-sectional tabulation of equity returns is provided in Table 5-14, which once again demonstrates the tax shelter benefits provided through proper use of leverage and depreciation deduction. In the case of Manhattan properties, the result was that equity returns registered a trend of uninterrupted increases throughout the five-year period. An especially interesting case is that of the six-story structures in the other boroughs, where tax benefits (due to book losses triggering tax refunds) were sizable enough to increase equity returns for the years 1964 and 1965 above their respective levels in Manhattan.

It thus appears that in those early years--when Manhattan properties, plagued as they were with persistent vacancies and relatively low property returns (the latter approximately equal to those earned by six-story structures in the other boroughs, according to Table 5-8)--the use of leverage and depreciation to gain tax shelter benefits was actually most potent in its application to the six-story properties. It was only in the last three years (1966-1968) that the combined effect of rising property returns and judicious use of leverage and depreciation deductions raised equity returns on Manhattan properties well above

TABLE 5-14

FHA SECTION 207 NEW YORK CITY SAMPLE-A CROSS-SECTIONAL TABULATION OF EQUITY RETURNS AT A FIFTY PERCENT TAX LEVEL, INCLUDING CONSIDERATION OF TAX SHELTER PROVIDED BY DEPRECIATION DEDUCTION 1964-1968 (ARITHMETIC MEAN OF SAMPLE)

Year	Manhattan	Other Boroughs		Total
	All Highrisers	Highrisers	Six-Stories	All Boroughs Six-Stories & Highrisers
1964	20.06	14.70	24.09	20.94
1965	20.65	14.30	22.84	20.21
1966	23.53	14.41	22.61	21.03
1967	27.76	14.85	21.96	22.28
1968	29.97	17.82	25.20	25.32

Source: FHA Section 207 New York City sample

all others.

Highrisers in the other boroughs again emerge as the "poorest performers" in comparison to Manhattan properties as well as to the six-story buildings in the other boroughs: the improvement in their equity returns, however, from 1964 (14.70 per cent) to 1968 (17.82 per cent) is more pronounced than the improvement in their property returns during the same period (5.76 and 6.17 per cent respectively, per Table 5-8).

4. The effect of governmental policies. Did governmental policies aid in the conversion of property returns to higher equity returns? As far as the availability of leverage is concerned, the existence of mortgage insurace through FHA should have and at times did (during the 1950's) facilitate the flow of mortgage capital into the construction of rental dwellings. The latter-day reluctance of financial institutions to divert additional funds into such activities must, therefore, be attributed to a fundamental weakness of the rental housing market: unsatisfactory property returns (actual and/or expected), returns that should in the final analysis provide the best guarantee to a mortgagee for an orderly and timely liquidation of his loan's principal, as well as for collection of interest due.[55] The public policy implications of this problem will be further explored in Chapter VI.

The other instrument in the hands of the government affecting equity return is its depreciation tax policy.

Recent developments in this field merit an examination at this point:[56] a review of the historical record since World War II reveals it to be sometimes, but by no means uniformly, preferentially disposed toward investment in real estate. As early as 1946, the 150 per cent declining-balance method "was extended by administrative action to buildings, with a particular view to assisting multiple-unit residential construction."[57] An even greater incentive was provided through legislative reforms manifested in the Internal Revenue Code of 1954, which allowed the 200 per cent declining-balance and sum-of-the-years-digits methods to be used,on all new depreciable assets acquired or constructed after 1953, with useful lives of three years or more. However, an added liberalization of depreciation policies which was introduced in 1958, excluded investments in real or intangible personal property; it permitted deduction of an additional first-year depreciation allowance equal to 20 per cent of the first $10,000 of new machinery and equipment acquired during the year, with a useful life of at least six years (IRC., Sec.179). Important tax reforms, both legislative and administrative, took place in 1962, excluding once again investment in real estate: the 1962 Revenue Act established a 7 per cent credit on investment in certain items designated as "qualified investment," which property was bought, built or rebuilt after 1961; the credit did not apply to buildings and their structural components. It should also be noted that

the credit was temporarily suspended for several months in 1966 and in 1967, and it was repealed by the 1969 Tax Reform Act. The year 1962 also saw the promulgagion, through administrative action, of shorter depreciation guidelines for lives of machinery and equipment, as well as for farm buildings. The provision of shorter lives was accompanied, however, by depreciation recapture safeguards (IRC., Sec.1245), meant to guard against "conversion of ordinary income into capital gains through resale of over-depreciated"[58] assets. A modified version of depreciation recapture was, however, applied to real estate through the 1964 Revenue Law (IRC., Sec.1250) which conditioned the amount of the recapture:on the length of time the property was held and the method of depreciation used in the following manner:

> If the depreciable real property is held over 10 years, there is no recapture, At the other extreme, if the property is held for only one year or less, there will be ordinary income to the extent of depreciation since 1963, provided of course there is that much gain. Between one year and 10 years the amount of ordinary income is a percentage of the lower of (1) 'additional depreciation,' and (2) gain. The percentage decreases after 20 months [by 1 per cent per month] "[59]

The 1969 Tax Reform Act bore most heavily on investment in real estate.[60] This sweeping tax reform provided for reduction in fast depreciation and recapture of more depreciation, applying the changes only to depreciable real property. While leaving in force the 200 per cent declining-balance

and the sum-of-the-years-digits depreciation methods in the case of new residential rental housing, the 1969 Tax Reform Act allowed the 150 per cent declining-balance method for all other new real property, and the 125 per cent declining-balance method for used residential rental housing with useful life of at least 20 years (instead of the 150 per cent declining-balance method previously allowed on such property). The minimal holding period required for total elimination of depreciation recapture was extended in the case of residential rental property from 120 months (10 years) to 200 months (16 years and 8 monghs), and in the case of other real property, a 100 per cent recapture rule was instituted, no matter how long the holding period.

It has indeed long been acknowledged that the investor in rental real estate enjoyed certain obvious tax benefits such as: accelerated depreciation formulas which--by extending over the entire cost of the property, including the substantial part financed by mortgagee--provided a very sizable tax shelter; the gain and loss treatment which, on the one hand, permitted losses on the sale of rental real estate to be fully deductible from ordinary income; while gains, on the other hand, were qualified for the more favorable capital gain treatment; limited recapture rules; deferment of tax on gain, through different methods of installment or deferred payment sales

as well as tax-free trading of the property "for other real estate held for investment so as to continue the build-up of tax-deferred gains."[61] This preferential attitude toward investment in real estate, which as shown above, was not conclusive and uniform, was meant to a large extent to encourage construction of much needed rental housing. Despite mounting criticism that some of these benefits (mainly accelerated depreciation coupled with the limited recapture rule) have provided incentive for excessive "turn over" of properties (sale of such properties after a limited number of years, once the optimal benefits of accelerated depreciation,which accrue mostly in the yearly years of acquisition, have been reaped), it has been demonstrated time and again--our analysis included--that liberal depreciation provisions were required to convert capital gains property returns into equity returns deemed satisfactory by real estate investors. The 1969 tax reform may therefore further dampen the investment enthusiasm of prospective builders of residential dwellings for the following reason: the investor's expectations of capital gains will have diminished severely because tighter recapture rules now provide for higher taxation of such gains after a given holding period, and because slower depreciation on used residential rental property (125 per cent declining-balance instead of the previously allowed 150 per cent) would cause it to be less

desirable for a subsequent buyer. It is therefore fallacious to argue that legislation which is meant to curb turnovers does not affect the readiness of an investor to construct a new rental property: the expectation of a sale at a gain after a reasonable period of time has long been a strong motivating force among real estate investors; the recent tax reform may have dimmed these expectations.

NOTES TO CHAPTER V

[1]Paul F. Wendt and Alan R. Cerf, Real Estate Investment Analysis and Taxation, (New York: McGraw-Hill Book Company, 1969), p. 13.

[2]Federal Housing Administration, How to Test Financial Soundness of Rental Housing Properties, p. 1.

[3]Typical of such misplaced emphasis on the effect of the cost of borrowed capital is Niebanck's following comment:

> "As in other cities, New York housing activity in 1967 and 1968 was at a very low ebb indeed, and this slack is directly attributable to the unavailability of reasonably-priced mortgage money."

Niebanck, op. cit., p. 22.

It seems, however, that the highly priced mortgage money did not have an exceedingly deleterious effect on the volume of office buildings construction in New York City, which peaked in the late 1960's concurrently with a decline in residential construction. The answer may be that office structures were deemed to be yielding a sufficiently high return that could sustain even a heavy burden of debt servicing, while expectations for residential properties were much less optimistic. Furthermore, it may well be argued--following traditional lines of economic reasoning regarding supply and demand--that with a high return on real estate properties, debt capital (as well as equity capital) will be attracted because of the possibility of earning a high rate of interest, with the result that such flow of capital into real estate will trigger an eventual easing of interest rates. Several authorities have in fact questioned the allegedly causative effect of interest rates on construction. Grebler, Blank and Winnick,who counted "three long cycles" in construction expenditures from 1889 to 1952, have concluded that the evidence:

> "fails to support any assumption of systematic, invariant relationships between the volume of new residential construction and the available indicators of the cost of borrowed funds. As one might expect, low or declining interest rates have not been a necessary condition for the expansion of housing construction. On the contrary, two of three observations suggest that new construction activity may expand in spite of high or increasing interest rates or may, in fact, be a cause of the upward movement in rates."

Grebler, Blank and Winnick, op. cit., p. 226.

The crucial importance of a sufficient yield on property--in the absence of which all other incentives be they admittedly powerful tax concession, etc., will be of little significance--was pointed out by Miles L. Colean who, after having acknowledged that "the 1954 revisions of the Internal Revenue Act provide powerful incentives to the application of risk capital to new income producing property," proceeded to state the obvious if sometimes overlooked:

> "It must be recognized nevertheless that these incentives apply only to propositions where the prospect is for net income, after operating expense and debt service, sufficiently high in the early years to make the allowances actually fruitful. They give little help to the property that is slow in establishing itself or that looks to a perhaps steady but comparatively low yield."

Miles L. Colean, "The Impotency of FHA Policies on Apartment Finance," Architectural Forum, 102, (June, 1955), p. 110. If, on the other hand, properties do sustain a sufficient return, capital should be attracted to them, construction is bound to proceed undeterred by the cost of capital, and the rise of the latter may,in fact,be restrained by an abundant supply. This process evidently took place in the early 1960's in regard to funds provided by savings banks (as pointed out by both Weaver and Klaman). Then Administrator of the Housing and Home Financing Agency and subsequently the First Secretary of the Department of Housing and Urban Development, Weaver concluded that one

> "major explanation for the heavy flow of funds into the residential mortgage market is, to use a popular phrase, that the price has been right. Net yields on residential mortgage loans have compared favorably with alternative returns from other forms of lending or investing activity throughout the postwar period."

See Robert C. Weaver, "Decent Housing for All," address delivered at the 44th Annual Meeting of the National Association of Mutual Savings Banks. Reprinted in Mortgage Financing Symposium, (Montclair, N.J.: The Consolidated Reporting Company, 1965), p. 44.

Klaman described the technical sequence of a process in which savings banks in the early 1960's were paying high interest rates, these in turn endowed savings accounts "with a new investment glamour." As a result there was a substantial net deposit inflow into savings accounts. Financial institutions, such as savings banks, faced an increased pressure on their earnings generated by the higher costs of funds and the need to offer higher rates on savings. This situation aroused new interest in mortgages, the highest yielding capital market instrument,

and as a result the mortgage-bond yield spread was narrowed. See Saul B. Klaman, "The New Look in Savings and Mortgage Market," address delivered at the 1962 joint annual meeting of the New Hampshire Association of Savings Banks and the New Hampshire Bankers Association. Reprinted in Mortgage Financing Symposium, (Montclair, N.J: The Consolidated Reporting Company, 1963), pp. 30-31.

Klaman has already indicated the importance of property return,among other factors, when he pointed out that FHA insured mortgages as well as VA guaranteed mortgages are judged by the market as to their quality based "to a large extent on their own merits nnotwithstanding the contingent liability assumed by the federal government." See Saul B. Klaman, The Postwar Residential Mortgage Market, a study by the National Bureau of Economic Research, (Princeton: Princeton University Press, 1961), p. 91.

We have thus come to realize that a sufficient return on property will not merely sustain a high interest mortgage capital, but it may in time even cause a reduction in interest costs. This conclusion is also supported by a recent survey of mortgage interest rates on income properties reported by fifteen life insurance companies. In his essay in the National Bureau of Economic Research Survey, "The Structure of the Mortgage Market for Income Property Mortgage Loans," Shipp stated an old truism, namely, "lenders 'reward' low risk borrowers with liberal terms and low interest rates." See Jack M. Guttentag and Phillip Cogan, (ed.), Essays on Interest Rates, Volume I, (New York: National Bureau of Economic Research, 1969), p.105.

[4]Grebler, Urban Real Estate Investment, p. 25.

[5]Ibid., p. 27.

[6]Sternlieb, Urban Housing Dilemma, p. 47.

[7]Lowry, op. cit., p. 25.

[8]A governmental commission described the situation that arose a decade ago when, in order to stem the drain on the balance of payments, "U.S. monetary policy in the early 1960's consciously sought, among other things, to raise short-term rates in this country to a level more in line with rates prevailing in Canada and Europe." See Commission on Mortgage Interest Rates, Report of the Commission on Mortgage Interest Rates to the President of the United States and to the Congress, (Washington, D.C.: Government Printing Office, August, 1969), p. 22.

[9]Rent Guidelines Board, Order Number 2--Rent Levels July 1, 1970 through June 30, 1971, (New York: The City Record, July 1, 1970). In a background statement, the Board justified the need for maintenance of parity in no

uncertain terms:

> "the returns on capital invested in similar long-term investments have shown dramatic rises, while rental residential property has been afflicted by a shortage of capital, available only at rates of yield much higher than those contemplated only a few years ago. Unless invested capital in residential real estate offers yields that compare reasonably with yields on similar long term investments, reinvestment for necessary repairs and major replacements will not be made, either by equity owners or by mortgagees. The condition of the structures would deteriorate certainly in such an investment climate, although the Board recognizes that the provision of a reasonable return does not by itself guarantee sound maintenance."

See page 2 of the statement.

[10] A detailed treatment of the subject is to be found in Robert E. Schultz, Life Insurance Housing Projects, (Homewood, Ill.: Richard D. Irwin, 1956). A short but sufficient summary is provided by Winnick, Opportunities for Private Investment, pp.121-130; and Fisher, Urban Real Estate Markets, pp.131-134.

[11] That statutory ceilings are not the cause of the life insurance companies' present-day limited investment program in real estate, may be learned from information provided by a major life insurance company located in a state adjacent to New York. Inswer to our questionnaire, which was circulated among these companies early in 1970, this company indicated that its investment in real estate fell below the statutory ceilings by the following amounts: 1964, $268,000,000; 1965, $294,000,000; 1966, $339,000,000; 1967, $1,002,000,000; 1968, $1,074,000,000. Notice the ever-growing increase in these amounts which must have resulted from a standstill on real estate investment (and possible divestiture) on one hand, and a growth in total assets on the other. (That particular state allows a maximum aggregate investment in so-called "Investment Real Estate" of 8 per cent of assets.) The dramatic rise in these amounts to over $1,000,000,000 during the years, 1967-1968, is especially disconcerting in its implications regarding the financing of massive housing. Further examination reveals that life insurance companies chose instead to increase their holdings of corporate bonds and stocks. Holdings of the former were increased from $58,698,000,000 in 1965 to $68,950,000,000 (estimated) in 1968, a rise of 17.5 per cent. The stocks portfolio rose from $9,126,000,000 in 1965 to $13,000,000,000 (estimated) in 1968, an increase of 42.4 per cent. Kenneth M. Wright, 1968 Economic Investment Report, (New York: Life Insurance Association of America, 1968), p. 24.

[12]It should be noted that the Johnson Administration prodded life insurance companies into a public commitment to invest in housing. Our own questionnaire resulted in an almost "evenly divided house." Of the seven companies that chose to answer the questionnaire, three answered the following question in the affirmative: "Does the company contemplate any new equity holdings of residential real estate in the foreseeable future?" Another three provided a negative answer, and one company ignored the question. One of the companies responding positively volunteered that it plans to "enter into joint ventures, through a realty subsidiary, with knowledgeable developers who have or are capable of obtaining expert management for apartment projects." Another company has similarly indicated a plan of operations "with experienced builder-operators." One of the negative respondents, on the other hand--a major life insurance company--stated that they "do not feel life insurance companies are appropriate vehicles for sponsorship and ownership of housing." It thus appears that several life insurance companies believe that a lack of technical expertise in the housing field may have hampered them in their attempts to realize a satisfactory yield on their investment, and some seek to overcome this obstacle through an association with experienced realtors.

[13]Several respondents have also pointed to the riskiness of investment in real estate and to the availability of safer alternative investments, thus implying that the return on investment in housing is not sufficient in view of the hazards associated with it.

[14]Winnick, "Long-Run Changes in Valuation of Real Estate," pp. 492-493.

[15]Sternlieb, Urban Housing Dilemma, p. 47.

[16]Lowry, op. cit., p. 25.

[17]Grebler, Blank and Winnick, op. cit., p. 421.

[18]Ibid.

[19]Winnick, Opportunities for Private Investment, p. 15.

[20]Some of the typical comments, which were made in response to our questionnaire, are reproduced below for, subjective as they are, in the anguish so often echoed by them, they may help to capture--possibly in a more effective way than figures and charts do--the utter

gloom and exasperation prevailing among New York City realtors, which seem to have been deepened by the rent stabilization legislation of 1969, and the subsequent extension of the rent control law in 1970.

The executive vice-president of a well-known realty firm which has built and/or managed highrisers in Manhattan, Forest Hills, Long Beach,and Florida wrote:

> "Any and all exhortations based upon facts and figures will do absolutely nothing to cause any change in the housing policies of both the Council and the Mayor. The extension of the present rent control statute is tantamount to having struck a thorough death blow to the housing situation in the City of New York. So long as the weaklings who run our government, see fit to play politics with housing, the owners and the tenants will not only continue to suffer thereby, but the suffering will grow more acute. More buildings will be abandoned and more builders and owners, like myself, will go elsewhere to invest their dollars."

The administrator of real estate management of a major life insurance company with headquarters in New York City wrote:

> "No owner or landlord or businessman is willing to lose money as the records have proven over the 27 years of Rent Control. The recent Rent Stabilization Law is more of the same. These laws protect the wrong people."

The same administrator answered the question: "Do you prefer construction and/or ownership of NYC residential properties to out-of-town properties?"by "prefer out-of-town," adding: "because there are no laws to contend with and the politicians face their problems more realistically. The Residential Real Estate Industry is dying." The administrator went on to suggest, "political morality and responsibility" in response to our request to list "any additional suggestions, comments, etc., that you may have, and which you believe may encourage the flow of funds for construction of multi-family rental properties in this city."

The comments provided by a corporate officer of a large construction and management firm may shed some light on the thinking of potential investors:

> "The institutions that normally invest in New York City are out of the Market because of Rent Controls and Rent Stabilization. They are afraid and rightly so, that the new buildings being constructed will eventually be placed under some control. Today with the attitude of the New York City administration we have shifted to out of town building and ownership, because we can finance the projects and have cooperation

> from the cities. Old rent control must be modified in order to give an owner of the property a return and enable him to 'keep-up' his property. Rent Stabilization was pushed through in a political election year. The only thing it has accomplished is that there is no movement in the real estate market. Rent Stabilization should be abolished and free movement in the market place should be allowed to take place."

The executive vice-president of a large realty management firm had this to say:

> "Our clients can get capital and financing and can build but will not, with the threat of Rent Control in future. They used to prefer NYC before last year [1969] but now our clients are buying and building out of NYC due to change in rent laws. Investors are staying from NYC residentials due to rent control. There is no protection to their investment. A free market would have helped but nothing will really help now that the City has reneged on a promise that post 1947 buildings would not be controlled."

Perhaps the most succinct reply was given by a vice-president of one of the very largest realty management firms in New York City. Having been asked to emphasize the most critical factors in the New York City housing shortage, he listed as number one: "Fear of Rent Control."

[21] It should be noted that the answers to our questionnaire make it amply clear that investors in debt instruments are similarly looking for properties that can provide and sustain the required return by themselves; they place little confidence in what may be called artificial measures to supply a minimal return. This became evident when, out of twenty-one responding life insurance companies and banks, eleven answered "no" to the question: "Would your company increase its mortgage holdings if yield insurance was available?" There was only one positive answer, while six registered uncertainty, and three ignored the question altogether.

[22] This term appears, for example, in the following Rand document: Thelma Palmerio, Mortgage Structure and Investment Return Rates for Ten "6&2" buildings, (Santa Monica, California: The Rand Corporation, July 10, 1969), (mimeographed), p. 5.

[23] The use, for example, of the relatively sophisticated internal rate of return measure would have posed formidable difficulties, some of which were pointed out by Grebler;

such as the need to know the value of a given property at the end of the period under review, in the absence of an "adequate index of real estate prices to estimate terminal values." See Grebler, Urban Real Estate, p. 130.

A recent analysis attempted to overcome this obstacle by presuming that the value of the property does not change over time. The analysis, however, arrived not at realized rates of return--which is our purpose--but at ex ante ones based on certain parameter assumptions. See Bruce Ricks, "Imputed Equity Returns On Real Estate Financed With Life Insurance Company Loans," The Journal of Finance, XXIV, (December, 1969).

[24]Grebler used the term "investment return" for the same yardstick. Grebler, Urban Real Estate, p. 111. Rapkin refers to the same by a somewhat longer and more descriptive term, " Net Operating Income as a Percent of Consideration." Rapkin, Real Estate Market in Urban Renewal, p. 66.

[25]Winnick, Opportunities for Private Investment, p. 106.

[26]Ibid.

[27]Ibid. Others have also dwelt on the value of the "free and clear" concept. According to Grebler, the "financial mix" assumption underlying this concept is

> "that there are no fixed debt charges against net operating income. The focus here is on the total net return thrown off by the properties rather than on the division of net earnings between various financial interests such as mortgages and equity owners."

See Grebler, Urban Real Estate, pp. 109-110.

[28]Sternlieb, Urban Housing Dilemma, p. 250. It should also be kept in mind that our investigation covers no more than five years, and the properties involved are relatively new, all of a post-World War II "vintage," with the great majority having been constructed in the late 1950's and the early 1960's. Physical depreciation of the properties has thus been kept at a minimum, with proper repair and maintenance outlays effectively restricting any possible deterioration. In the case of older housing, however, with an analysis extending over the long-run, the effect of depreciation on property values should not be lightly dismissed.

[29]According to Niebanck, the period 1962-1965 "displayed an abnormally high rate of new construction" while "the years immediately following 1965, on the other hand, displayed a much slower rate of new construction." op.cit., p.219

[30]The present analysis relates property returns to rental market conditions while ignoring rent ceilings imposed by the FHA on Section 207 properties. This approach is fully justified by the plain fact that property returns during the period 1964-1968 have usually been under 7 per cent (as shown in Table 5-1), which is well below the annual allowable return on investment set by the FHA. Using the formula set by the latter agency in the form titled, "Basic Rent Formula Supplement To Form 2264 Maximum Allowable Gross Rental-Multifamily Housing," it appears that the ceiling would not have been below 8 per cent. Winnick, in fact noted that as long ago as 1952, the FHA considered 7 per cent per annum on original construction costs as a minimum return. Winnick, Opportunities for Private Investment, p. 120. It is therefore evident that market conditions influenced rent levels of Section 207 properties in New York City during the period under consideration, much more than FHA regulations, and the conclusions arrived at in these pages are therefore applicable, to a large extent, to other privately financed non-rent-controlled residential properties in the City as well.

[31]Winnick quite correctly pointed out that,

> "what the current rate of return on alternative investment opportunities may be for any individual investor depends on what particular alternatives he sees. But, for investors as a group, it is conventional and justifiable to use current yields on Federal bonds or high-grade corporate securities as the base index against which all other investments will be scaled."

Winnic, Opportunities for Private Investment, p. 103.

The yield on these high quality bonds, which are almost riskless from the investor's point of view, may be considered as setting a minimum point on an index, with other investments of lesser quality requiring correspondingly higher returns. One researcher has indeed concluded, that the "pattern of bond yields provides the best single picture of general monetary conditions." Albert Schaaf, "Federal Interest Rate Policy on Insured and Guaranteed Mortgages," (Unpublished Ph.D dissertation, University of California, 1955), p. 85. It should also be noted that Hickman, in his well-known study of corporate bonds defined "quality bonds" as those rated high grade by the investment rating agencies, bonds eligible for savings banks, and personal trust investment in selected states, and bonds rated high grade by the market. W. Braddock Hickman, Corporate Bond Quality and Investor Experience, (Princeton: Princeton University Press, 1958), p. 29.

[32]Some of the lesser mentioned unique characteristics

of investment in residential real estate have been recently pointed out by Sternlieb: (a) In many cases ownership of real estate requires a great deal of labor on the part of the landlord. While these efforts are not reflected on the financial statements, "real estate in order to attract investment must provide a higher rate of return than alternative outlets such as bonds, which do not require effort from the investor." Sternlieb, Urban Housing Dilemma, p.195. (b) the public has increasingly tended to cast rental property ownership in a negative social role identifying it with heartless exploitation of poor tenants:

> "The terms landlord, slumlord and a general no-goodnick, all are frequently interchangeably used. As such, the rates of return required must yield not only an adequate investment recompense, but also make up for the negative status consideration."

Ibid., p. 922.

Among the more traditionally mentioned differences in investment characteristics between rental properties on one hand, and quality bonds on the other, is the greater risk-due to a higher volatility--that attaches to the former. Grebler, in documenting the generally satisfactory experience of investment in real estate in the period 1900-1930 versus the disappointing record of later years, has demonstrated the "greater volatility of annual returns on real estate investments as compared to those on fixed-debt obligations." Ibid., p. 170. His overall conclusion in view of the evident volatility of real estate investment returns was that "net returns on long-term investments in the properties included in this study, have been lower than one would expect considering the risks involved in real estate investment: the instability of gross and particularly of net earnings." Ibid., p. 25.

The demonstrated volatility of investment in real estate has been, according to Schultz, a factor limiting broad participation by life insurance companies in investment in housing. The combined yield since 1948 for all life insurance companies' housing projects, has registered large yearly fluctuations, and it was not sufficiently high to compensate for such an erratic movement. See Schultz, op. cit., pp. 98-99. The relative lack of liquidity--another characteristic of investment in real estate as contrasted with investment in securities--did not deter life insurance companies, according to Schultz, due to the long term nature of their contractual obligations.

Winnick has summarized investment risks in rental housing as follows:

> "The high risk factor attached to residential real estate is due to its longevity, immobility,

> exposure to social controls, and the poorly organized market mechanism for buying and selling. The period of time necessary to amortize the full cost of the property out of operating earnings is long. During this period, operating income is subject to wide fluctuations. Since the market for housing services is localized, earnings are dependent upon not only the state of national economy, but of the local economy as well."

Winnick, Opportunities for Private Investment, p. 99.

[33]One is reminded of Grebler's finding in regard to an earlier era: "these differentials [between returns on long-term real estate investments and investments in fixed-debt obligations] in practically all comparisons after 1930 were narrowed to a point where they would be considered inadequate to attract and maintain the employment of long-term capital funds in real estate." Grebler, Urban Real Estate, pp. 172

[34]Beginning with the second half of 1965, the Life Insurance Association of America commenced a quarterly survey of mortgage loans of $100,000 and over, committed by fifteen life insurance companies on multifamily, commercial, industrial,and institutional properties. The reporting companies accounted at the time for 58 per cent of the assets and 55 per cent of the total mortgage loans on urban property held by all United States life insurance companies. The mortgage survey was one of the results of the Study of Interest Rates that was conducted by the National Bureau of Economic Research under the sponsorship of the Life Insurance Association of America. For more on the subject, see Guttentag and Cagan, op. cit.; Robert J. Lindsay, The Economics of Interest Rate Ceilings, (New York: New York University School of Business Administration, Institute of Finance, 1970); and the Report of the Commission on Mortgage Interest Rates.

[35]Winnick, Opportunities for Private Investment, p. 16.

[36]Fred E. Case, Los Angeles Real Estate: A Study of Investment Experience, (Los Angeles: University of California, Real Estate Research Program, 1960).

[37]Winnick, Opportunities for Private Investment, p. 269.

[38]James, op. cit., p. 12.

[39]According to an official publication, "an equalization rate indicates the relationship of the assessed valu-

ation of taxable property in a locality to the full value of that same property; in other words, the equalization rate indicates the percentage of full value at which the assessor in a locality is assessing on the average. Mathematically, the equalization rate is computed by dividing the total taxable assessed valuation of the locality by the total taxable full value thereof." State Board of Equalization and Assessment, Principles and Procedures Used In Establishing State Equalization Rates, (Albany: State of New York, February,1961, revised January, 1963), pp. 4-5. The manual later states that under court decisions "full value is market value (the price that would be paid by a willing buyer to a willing seller) in a normal market." Ibid., p. 8.

40 See "Council Passes Major Revisions in Rent Control," New York Times, June 28, 1970, Regulations under the earlier law allowed hardship applications for increase in maximum rents of rent-controlled properties whenever the property yielded a net annual return of less than 6 per cent of its assessed valuation (rather than equalized assessed valuation). Such return was computed, however, after inclusion in operating expenses of an allowance for depreciation of 2 per cent of the value of the building. See Office of Rent Control, Rent and Eviction Regulations, (New York Housing and Development Administration, September 1, 1968), pp. 19-20. The latter so-called "fair-net-return formula of 6 plus 2" was most recently criticized by the Mayor's Rent Control Committee as "meaningless during a time when interest rates alone are far in excess of the return provided by the formula." The committee suggested that "if the fair-rent return concept is to be continued as a feature of rent control policy in New York City, it should be computed at a flat rate of no less than 9 per cent of assessed value." See The Mayor's Rent Control Committee, op. cit., p. 34. A further-reaching suggestion was made by Kristof who proposed that "a financing-equity return of ten per cent on the higher of assessed value or the sales price on an existing structure is an approach to reality in contrast to the '642' formula." Frank S. Kristof, "Housing: Economic Facets of New York City's Problems," Agenda for a City, ed. by Lyle C. Fitch and Annmarie Hauck Walsh, (Beverly Hills, Cal.: Sage Publications, 1970), p. 315. The ensuing legislation allowed however (as indicated above in the text), for an eventual return of 8.5 per cent of equalized assessed valuation. In any case, the heavy reliance by numerous authorities on property return in relation to assessed valuation is significant.

[41] Equalization rates for the City of New York for 1964 and 1968 were as follows:

	1964	1968
City-wide	74	71
Bronx County	81	75
Kings County	68	63
New York County	83	83
Queens County	64	61
Richmond County	64	62

Source: State Board of Equalization and Assessment, State Equalization Rates for Assessment Rolls of Cities, Towns and Villages, (State of New York: November, 1965 and October, 1969 respectively), p. 14.

In his recent study, Sternlieb used a current assessment-to-market ratio of 70 per cent for 1968-1969 appraisals. Sternlieb, Urban Housing Dilemma, p. 263.
We have utilized the borough-wide equalization rates for 1964 and 1968 as shown above.

[42] The market place thus acts as the "great equalizer"--by shrinking the values of properties which are "poor performers," it brings the return on them into line with those generated by properties with a more superior income record (subject to adjustments for risk, etc.). Thus, an investor in the former (i.e., the "poor performers") may not necessarily do worse than the one who acquired the latter, and vice versa, provided that the income qualities of their respective properties have been recognized and duly reflected in the market prices prior to their acquisitions of these investments. The ones to suffer are those who acquired supposedly high-income potential properties which then generated profits below expectations, for the shrinkage in market value will in all probability take place during their tenure of ownership. The analogy to investment in the stock market is of course obvious. It is thus of interest to note that Rapkin established what may seem to be a relatively high average rate for the time of net operating income as a per cent of assessed value for elevator buildings in the deteriorating upper West Side of Manhattan in 1955-1956, 8.6 per cent (7.5 per cent after adjustment for equalized assessed valuation). Rapkin, Real Estate Market in Urban Renewal, p. 119. The meaning of this figure was simply that the market has already discounted the prices of these properties to bring them in line with their operating income. Similarly, Sternlieb's recent data showed for the rent-controlled sector, older properties yielding a higher imputed income as a percentage of

total assessment than newer properties in 1967: a mean of 7.23 per cent for old law structures containing 20 units or more, versus means of 6.01 and 5.32 per cent for new law structures and structures built after 1929, respectively, and containing 50 units or more. Sternlieb, Urban Housing Dilemma, p. 293.

It is suggested here that these differentials in rates demonstrate the severity with which the market place has reacted to the proven income limitations of the older properties, depressing their prices so that even a very modest operating income will suffice to yield a return of 6-7 per cent in relation to these low prices. The lower return on the newer properties indicates, on the other hand, that they are still enjoying a "grace period" granted by the market place during which a more decisive evaluation of their income-producing ability will be made.

[43]It should be noted that FHA insured mortgages which are amortizable over a forty-year period are subject to interest ceilings. In a letter dated August 26, 1970, Mr. Carl A. Spencer, Deputy Director, Division of Research and Statistics of the Federal Housing Administration, stated that "the regulatory maximum interest rate for Section 207 projects was 5.25 per cent from September 23, 1959 to May 7, 1968. From May 7, 1968, to January 24, 1969, it was 6.75 per cent." However, a note of caution is due here, free market rates tended usually to be higher than the regulated ones, and FHA insured mortgagees adjusted for the difference by charging "points" for the granting of a government insured loan. Such points, though being in reality an additional interest cost, were not reflected as such on the financial statements of the mortgagor, and to this extent there was an understatement of interest expense on the income statement.

[44]A recent article has called attention "to the meager data base for rates of return on equity investment in real estate." See Ricks, op. cit., p. 921.

[45]The exclusion of the amortization of mortgage principal component of the total outlay on debt servicing should be kept in mind when comparison is attempted with other so-called equity returns,which do take into consideration debt amortization, thus constituting in reality a net cash flow analysis.

[46]This assumption is not far fetched. Real estate investment has long been considered as a prime tax shelter for persons with sizable ordinary taxable income from other sources, such as doctors and other highly paid professionals, executives and successful businessmen, etc. A number of

popular tax manuals, as well as other publications containing financial advice, have discussed these aspects of real estate investment in great detail. See, for example, William J. Casey, Real Estate Investments And How To Make Them, (New York: Institute for Business Planning, 1965).

[47]Palmerio, op. cit., p. 6.

[48]Ibid.

[49]Ibid., p. V.

[50]Sternlieb, Urban Housing Dilemma, p. 581.

[51]Wendt and Wong, op. cit., p. 646.

[52]Ibid.

[53]Winnick, Opportunites for Private Investment, p. 238.

[54]Ibid.

[55]Our FHA Section 207 New York City sample computations show, for example, that in 1968 debt servicing charges (annual amortization of mortgage plus interest payments excluding tax considerations) averaged 95.78 per cent of income on a "free and clear" basis. This high percentage leaves preciously little "cushion" for protection of creditors; a slight drop in property returns would thus mean inability to service debt obligations in full.

[56]This review is based to a large extent, but not exclusively, on material provided by Leavey, Hodge and Hauser, op. cit., pp. 12, 13, 43, 44. Additional suggested sources are tax guides such as: 1971 Federal Tax Course Students Edition (Englewood, N.J.: Prentice-Hall, Inc., 1970), and the Tax Coordinator: '69 Tax Reform Law, (New York: The Research Institute of America, 1970).

[57]Leavey, Hodge and Hauser, op. cit., p. 43.

[58]Ibid., p. 44.

[59]Wendt and Cerf, op. cit., p. 114.

[60]According to a newspaper article, the bill "hit real estate men as hard as, if not harder than, any other segment of the economy." See "Tax Reform Impact Heavy in Real Estate Investment But Realty Men Attack Measure," New York Times, September 14, 1969, Sec. 8, p. 1R.

[61]Leavey, Hodge and Hauser, op. cit., p. 13.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS

A. New York City Housing Shortage: A Grave And A Growing Crisis

1. The combined effect of declining construction and increasing abandonment. The gravity of the housing crisis in New York City is by now a widely acknowledged fact, which is most dramatically expressed in the 1968 miniscule vacancy rate of the City rental housing sector; 1.23 per cent. A significant deterioration has thus taken place since 1965 at which time the corresponding rate was 3.19 per cent. The crisis is unrelenting indeed, it has been foretold through an unmistakable trend of a constant decline in construction of residential housing units in New York City ever since the mid-1960's, and--as the latest available information indicates--the crisis has continued unabated to the very present day. It appears from Table 6-1 that by the end of the ten-year period 1961-1970, residential construction activity has dwindled to an annual total below 20,000 dwelling units, or

TABLE 6-1

NUMBER OF NEW HOUSING UNITS BASED ON BUILDING PERMITS ISSUED, NEW YORK CITY, 1961-1970

Year	Number of Units
1961	70,606
1962	70,686
1963	49,898
1964	20,594
1965	25,715
1966	23,142
1967	22,174
1968	22,062
1969	17,031
1970	19,671
Total 1961-1970	341,579
Annual Average 1961-1970	34,158

Source: New York State Division of Housing & Community Renewal. Current figures appear in the monthly publication, Construction Activity in New York State Based on Building Permits Issued.

TABLE 6-2
HOUSING LOSSES THROUGH ABANDONMENT, NEW YORK CITY
1960--1969

Year	Number of Units
1960	1,000
1961	2,000
1962	2,000
1963	4,000
1964	8,000
1965	12,000
1966	18,000
1967	20,000
1968	20,000
1969	18,000
Total 1960-1969	105,000
Annual Average 1960-1969	10,500

Source: New York Times, Sec.8, March 14, 1971, p. R6. Estimates and distributions by years, by Frank S. Kristof, based on 1960 and 1970 census figures and city records.

slightly more than half the annual average for the decade.

The evident decline in residential building in New York City, while being undoubtedly the major factor contributing to the housing shortage in the City, has been accompanied by another hazardous phenomenon: abandonment of substantial numbers of existing dwelling properties by their owners. While no reliable official statistics exist, Frank Kristof, a noted housing economist, has recently calculated an abandonment loss for the ten-year period, 1960-1969, of approximately 105,000 dwelling units, an annual average for the decade of some 10,500 units. The most disturbing fact, however, is that losses in recent years (as indicated by Table 6-2) have been approximately twice the decade's annual average. Comparing Tables 6-1 and 6-2, and bearing in mind that actual housing losses are even larger, due to demolitions and mergers (conversion of units to non-housing uses), in addition to abandonments, the conclusion is inescapable that recent years have been marked by a stagnant rate of growth in the housing supply of New York City at best, or by an outright decline in the City housing inventory at worst.[1]

2. Cessation of unsubsidized private residential construction. Additional analysis of the available data (Table 6-3) reveals that the near-termination of housing construction in New York City was due to the almost total

TABLE 6-3

NUMBER OF HOUSING UNITS BASED ON BUILDING PERMITS ISSUED, BY TYPE OF FINANCING, NEW YORK CITY 1961-1970

Year	Conventional (Including FHA Sec.207) No. of Units	Conventional (Including FHA Sec.207) Percentage of Total	Government Aided (NYS, NYC, Fed.) No. of Units	Government Aided (NYS, NYC, Fed.) Percentage of Total	Total
1961	50,352	71.3	20,254	28.7	70,606
1962	52,384	74.1	18,302	25.9	70,686
1963	39,850	79.9	10,048	20.1	49,898
1964	14,565	70.7	6,029	29.3	20,594
1965	15,244	59.3	10,471	40.7	25,715
1966	11,394	49.2	11,748	50.8	23,142
1967	11,778	53.1	10,396	46.9	22,174
1968	10,422	47.2	11,640	52.8	22,062
1969	9,244	54.3	7,787	45.7	17,031
1970	6,785	34.5	12,886	65.5	19,671
Total 1961-1970	222,018	65.0	119,561	35.0	341,579
Annual Average 1961-1970	22,202	65.0	11,956	35.0	34,158

Source: New York State Division of Housing and Community Renewal

cessation of private,unsubsidized, so-called "conventional" residential building activities in the City. Traditionally, the private sector constituted the mainstay of the housing supply, providing well over two-thirds of all new dwellings in the early years of the past decade, but gradually the role played by this sector has declined to approximately a third of all new residential construction in 1970. Concurrent with the diminishing significance of the private sector, government-aided housing activities assumed growing importance, rising from less than a third of the total construction in 1961 to about two-thirds in 1970. The experience of a decade (as summarized in Table 6-3) demonstrates, however, that government aided housing was not capable of providing the dwelling units which were not built due to the collapse of the private sector. While undoubtedly growing in importance, publicly aided residential construction has remained to date, a slow and painfully insufficient replacement to a rapidly vanishing private sector.[2]

Focusing our attention at this point on the New York City insurance activities of the Federal Housing Administration, we witness a trend paralleling the behavior of the City housing construction market in general. As Table 6-4 indicates, the early 1960's were marked by the undisputed dominance of conventional housing insurance (Section 207) by the FHA. But as the rest of the unsubsidized private

TABLE 6-4

MULTIPLE-FAMILY HOUSING MORTGAGES INSURED BY FHA IN NEW YORK CITY, 1963--1969

Year	Section 207		Other Sections		Total
	Number of Units	Percentage of Total	Number of Units	Percentage of Total	
1963	11,616	95.2	580	4.8	12,196
1964	5,242	84.5	959	15.5	6,201
1965	2,166	45.8	2,565	54.2	4,731
1966	422	19.7	1,725	80.3	2,147
1967	0	0	2,091	100.0	2,091
1968	0	0	1,856	100.0	1,856
1969	0	0	2,038	100.0	2,038

Sources: 1963-1967, David Dreyfuss and Joan Hendrickson, A Guide to Government Activities in New York City's Housing Markets, (Santa Monica, Cal.: The Rand Corporation, 1968), p. 49.
1968-1969, Unpublished data from the Federal Housing Administration, Washington, D.C.

sector halted its residential construction activities, we notice a rapid decline and utter elimination of all insurance under Section 207 of the National Housing Act. Instead, the Federal Government was called upon to provide insurance for a variety of subsidized programs (under Sections 213, 220, 221, 231, and 233). However, it should be noted that as with the rest of the housing market, the publicly aided programs were indeed a poor substitute--as far as the number of dwelling units built is concerned--to the conventional construction, resulting in a net decrease, between 1963 and 1969, in the annual total of new units insured by the FHA in New York City. This is an interesting development, for it demonstrates that the mere availability of government insurance will not suffice to attract builders and investors of conventional housing in such properties. Once again, it is shown that investment in Section 207 rental housing is subject to the operation of strong underlying market forces similar to the remainder of the conventional rental housing sector. When these forces were favorable, residential construction, Section 207 included, peaked; with the elimination of these conditions, private construction of residential housing--Section 207 providing no exception--came to a standstill: federal insurance by itself could not counteract the effect of the market. Government agencies, as we have seen, concentrated instead on "housing for the poor and the near poor."[3]

As far as private unsubsidized multifamily housing construction is concerned, investors--including lenders--have tended to emphasize the primary role of conventional considerations of property returns. It may therefore be concluded that the mortgage insurance program under Section 207 of the National Housing Act is by itself of little value in inducing otherwise reluctant realtors and lenders to invest in the construction of multifamily rental housing. Profitability of investment and governmental policies that do not interfere with the traditional role of market forces provide a more powerful incentive to builders of conventional non-subsidized housing than does the insurance program under Section 207.[4]

3. The value of unsubsidized private residential construction. The failure of the various governmental programs to provide badly needed massive housing should assist in reawakening the interest of the general public in private unsubsidized housing, and may further lead to recognition of the benefits accruing to the population at large from conventional residential construction activities on a large scale. That government-built housing for the poor can be of limited proportions only, volume-wise, is dictated by the high costs per dwelling unit that are involved, and which the public is called upon to bear. Noting that in addition to outright federal subsidies for public housing, interest earned by investors in bonds of local housing authorities is exempt from both federal

and local income taxation, while the housing projects enjoy an exemption from local real estate taxation, Irving Welfeld recently concluded that "by choosing to provide new housing for our poorest citizens, the federal government has adopted a most expensive strategy for increasing the nation's housing supply."[5]

The argument has been made, however, that private conventional housing construction in New York City will result in luxury "housing for the rich," to the exclusion of moderate and low-income families in need of decent housing facilities. While it is true that high construction and finance costs will of necessity dictate high rentals in new conventional accommodations, the economic mechanics of the market are such that all will benefit--at least to some extent--from renewed construction. Otherwise we would be arguing that the present situation, in which there is an absence of construction, is no worse than one in which new residential units in significant numbers are added to the housing stock. With a greater supply of housing in the City of New York, a "filtering" process is expected to follow, namely, as the more affluent will move into newly constructed housing units, they in turn will vacate lower rental accommodations that will be made available to tenants of successively more limited means. The net result of such a "chain of moves" is an improvement in residential facilities for the affluent as well as the poor. While the latter will not be occupying brand new housing, they

will nevertheless find their newly occupied accommodations prefereable to the ones they vacated. The applicability of this theory to New York City, as well as to the rest of the country, has been documented in recent studies.[6]

4. Reasons for shortage. Concomitant to a growing awareness of the need for renewed conventional housing construction, coupled with termination of large-scale abandonment of dwelling accommodations,[7] is the voluminous recent literature on the reasons for the housing shortage. There is a consensus that the present crisis has resulted from a variety of factors ranging from the socio-economic to the strictly financial.

Population changes are, without doubt, one such factor. Thus, the Rand Study mentions "massive ethnic and social changes in the City's population in recent years,"[8] and Sternlieb, a noted housing economist, similarly states that "welfare and tenant ethnicity are key factors affecting investment."[9] The ethnic change has been manifested in a continuous decline in the size of the white population of New York City coupled with a corresponding rise in the number of non-whites and Puerto Ricans.[10] While demographic considerations by themselves may affect the investment decisions of realtors and lenders in regard to socially changing neighborhoods, in the case of New York City the situation has been aggravated by an out-migration of skilled workers with higher incomes and in-migration of the unskilled.[11] The City's welfare rolls confirm in no uncer-

tain terms the above-mentioned trend:

> Expenditures have increased over the past two decades, and dramatically over the past four years. In the fiscal year 1965-66, welfare expenditures in New York City were close to $0.5 billion. In fiscal year 1967-68, expenditures approached $1.0 billion; in fiscal year 1968-69, they totaled $1.5 billion, exclusive of the cost of Medicaid. Estimates for the fiscal year 1969-70 indicate that expenditures will total $2.0 billion.[12]

The endless growth of welfare expenditures of course saps the financial strength of the City, and it may shake the confidence of realty investors in the economic viability of residential housing in New York City.

Restrictive zoning regulations are another weighty factor noted time and again. Thus Kristof, in calling for a zoning overhaul, concludes "that drastic steps must be taken to rezone large areas of Manhattan and some strategic areas in the other boroughs to permit substantially greater density in locations where higher densities can be justified."[13] Professional builders and developers have similarly stated that

> A major hindrance involves zoning restrictions which prevent needed economic density, even in high-rise Manhattan. Everywhere around the nation, zoning prevents apartment building in parts of suburbia; here [in New York City] the problem is lack of sufficient coverage rather than zoning for apartments per se. Additional units per site are necessary to counter the city's fantastic construction and maintenance costs.[14]

Steeply rising construction costs may be another factor inhibiting large-scale building. Between 1965 and 1968 building costs in New York City rose by an average annual rate of 5.7 per cent, the rise in the following year, 1969,

was mild in comparison, 3.8 per cent; but subsequently, in 1970, it increased to 8.0 per cent.[15]

There are undoubtedly other factors that may be considered in an analysis of the reasons for the housing shortage in New York City, such as interest and finance costs, punitive building code enforcement,[16] etc. The traditional role of revenue considerations in housing investment decisions remains, however, unique and unchallenged. According to the Rand study, the "basic deficiency" is that of"inadequate revenue."[17] Rand's suggestion is therefore:

> that the first priority of City housing policy should be to redress the existing imbalance between rental revenues and costs in a way that provides a long-run incentive for preventive maintenance. Unless this is done, we anticipate continued decline in housing quality, continued high rates of inventory loss, intensification of landlord-tenant anatagonisms, and a permanet shortage of rental housing.[18]

Sternlieb's study has also focused attention on the severe financial problems that have been attached to the ownership of rent-controlled housing in New York City: current yields are unsatisfactory, operating profit is not sufficient for improvement of maintenance, and the real estate tax is a significant cause of "operating strain." Not surprisingly, Sternlieb noted among owners "a pervasive crisis of confidence in the future,"[19]and he associated the lack of future expectations with "a weakening definition of property" which threatens the security of investment.[20]

B. Purpose and Findings of the Present Study

It was the aforementioned housing crisis in New York City that prompted us to undertake the current analysis in the belief that:

(a) there is a need for reliable housing investment data by both prospective investors and the makers and formulators of public policy, and (b) a prerequisite for renewed private residential construction activity in New York City is wise public policy which is based on such data. The study sought to analyze the operating results of non-rent-controlled apartment buildings in New York City by utilizing the financial statements for the period 1964-1968, of a randomly selected sample of 78 multifamily rental properties, whose mortgages are currently insured by the Federal Housing Administration, under the provisions of Section 207 of the National Housing Act. The decision to use data of Section 207 properties was based on the availability and reliability of the applicable financial records on the one hand, and the fact that these properties were subjected to the operation of market forces similar to those affecting the rest of the non-controlled rental housing sector in New York City. It was felt that while a considerable body of data has been accumulated recently on the results of investment in rent-controlled properties, less than enough is known in regard to non-controlled rental housing--a sector that will require

the attention of public policy formulators in the near future, if a repetition of the financial plight besetting the controlled sector is to be avoided, and large-scale residential construction is to be resumed.

The major findings of our study will be summarized below. As was made clear earlier, the findings are based on financial data of FHA Section 207 properties; but,as also shown earlier, they are largely applicable to the New York City non-rent-controlled residential housing sector in general.

1. The rise in operating expenses during the period 1964-1968 has exceeded that of revenues. The average annual increase for the former, amounted to approximately 5.7 per cent as compared with approximately 4.7 per cent for the latter. However, both revenues and their major component, gross rents,increased at noticeably higher annual rates during the latter part of the period, while the annual rate of increase in operating expenses began to decline during that time.

2. Increases in gross rents were modest not only in relation to the rise in operating expenses, but also in comparison to rent increases in the controlled sector, as well as the rise in incomes of tenants in the never controlled sector. As pointed out by Sternlieb, rents in controlled dwellings increased during the period 1964-1967 by 2.2 per cent per annum, while the corresponding increase for FHA Section 207 properties was approximately 2 per

cent. Median income of tenants in the never controlled sector rose during the period 1965-1968 by 4 per cent per annum. The corresponding rate of growth in gross rents of FHA Section 207 properties was approximately 3.4 per cent.

3. The rise in operating expenses exceeded that of similar expenses in controlled properties. Between 1965 and 1967, operating expenses of the latter increased nearly 10 per cent, according to Sternlieb, as compared with approximately 15 per cent for FHA Section 207 properties. Analysis of individual discretionary expense items, shows a substantial average annual increase in repairs and maintenance for the period 1964-1968, approximately 14.3 per cent, and a minor increase in other operating expenses (largely payroll), approximately 1.7 per cent. In other words, while the increasing housing shortage may have allowed landlords of non-controlled properties to cut down on certain expenses which are considered by them as selling expenses--outlays required to attract tenants--they did not neglect the maintenance and repairs of such properties, but chose rather to keep the properties at a relatively high level of physical maintenance, which is apparently necessary if the value of the property is to be preserved and even enhanced for capital gain purposes.

4. A relatively high level of operating expenses per room was demonstrated by the non-rent-controlled properties. FHA Section 207 properties in 1968 had average

total monthly operating expenses (on a per room basis) of approximately $28.00 , consisting of $12.00 mandatory expenses (i.e., real estate tax) and $16.00 of mostly discretionary expenses. The most expensive controlled structures on the other hand, had total monthly operating expenses in 1967 (on a per room basis) of only $20.00--with discretionary expenses not exceeding $12.00. The operating expenses of the non-rent-controlled properties have apparently exceeded the average expenses per room for most other locations in North America.

5. Property returns during the period 1964-1968 have "hovered" around the 6-7 per cent mark. No perceptible improvement was registered until the very end of the period under review, 1968, at which time the average return approximated 7 per cent, as compared with approximately 6 to 6.50 per cent for the earlier four years. As a result, the traditional "spread" between such returns and yields on bonds continuously shrank: the "spread" between property returns and yields on corporate bonds was reduced from approximately 1.50 to 2 per cent in 1964, to well below 1 per cent in 1968. The relative advantage of an investment in non-rent-controlled property in New York City, over investment in a portfolio of corporate debt obligations, has seriously declined. The use of "leverage" (debt financing) and the availability of the depreciation deduction for income tax purposes have helped, however, to convert relatively low property returns to higher equity returns, with greater

benefits accruing to real estate investors in higher tax brackets.

6. The real estate tax is the largest single operating expense item. This property tax, in 1968 consumed approximately 25 per cent of the "revenue dollar," and over 44 per cent of the "operating expense dollar" of FHA Section 207 properties in New York City: it amounted to $12.00 per room per month. Actually a tax on consumption, it is unparalleled in its magnitude--some 33 per cent of housing consumption--by any other excise or sales tax. Over the last 40 years or so, the tax has shown a general tendency to consume a bigger portion of the "revenue dollar," and it now appears that the rent dollar of non-controlled apartment properties in New York City, is amongst the most heavily taxed shelter monies in North America.

7. A mood of pessimism and a low degree of confidence in the future of private residential construction in New York City were noted in our written and oral communications with traditional investors in real estate. Rather disturbingly, this point of view is common not only to owners of interests in rent-controlled properties, as indicated by Sternlieb, but also to investors in non-rent-controlled housing, who regard the enactment of the 1969 Rent Stabilization Act as a breach of promise to exempt post-1947 residential construction from rent controls. Based on the present mood and expectations of these entrepreneurs, prospects for future private construction on a large scale seem dim indeed.

C. Implications for Public Policy

How are we to measure the success or possibly the failure of a given public policy on residential housing? Multiple answers may be offered setting up different, and in all probability conflicting, criteria. Naiveté alone would prevent us from realizing that a suggested solution is colored to a large extent by one's political persuasion and/or his special interests. Furthermore, any sober assessment of the options which are available to the makers and formulators of public policy cannot ignore the fact that New York City is predominantly a city of renters. For each dwelling unit that is occupied by a homeowner (including cooperatives) there are three and more units that are rented. A majority of the latter, almost two-thirds, is rent-controlled.[21] Tenants' wishes and interests--the bulk of whom reside in rent-controlled apartments--are bound, therefore, to play a major role in the formulation of the City housing policy.

Yet, despite the controversy and the varied points of view, it should be possible to define some minimal grounds, a desired goal to be attained. Alleviation of the housing shortage and the availability of additional dwelling accommodations, are without doubt <u>a minimum</u> to which the community will subscribe. To this extent a mutuality of interests, which is broadly based and sufficiently so,

may be established. Since the New York City Rent Stabilization Law of 1969 is unquestionably one of the most important recent expressions of public policy in regard to local housing, based on our findings and in light of the criterion set forth above, it should be evaluated first. Next, our attention will be turned to the major operating expense item, the real estate tax.

1. The Rent Stabilization Law of 1969. The RSL, as mentioned earlier, "stabilizes" rent increases in non-rent-controlled multifamily rentals in New York City, which were constructed no later than March 10, 1969. Rents charged on May 31, 1968 were set as a base, and a newly formed Rent Guidelines Board was empowered to establish annually, on July first, a level of fair rent increases, as a guideline for rent increases of renewal leases of different durations, as well as vacancy leases. Statutory ceilings limited the guidelines for the first year to 10 per cent and 15 per cent for two-year and three-year renewal leases, respectively, and to 15 per cent and 25 per cent for two-year and three-year vacancy leases, respectively. In establishing the guidelines, the Board is required to consider, among other things, prevailing and projected operating as well as financing costs, and current and projected cost-of-living indices.[22] The law further authorizes another panel, the Conciliation and Appeals Board, to grant upon application, permission for rent increases exceeding the level of fair rent increases, where a hardship (known as

"comparative hardship") would otherwise result, namely; a failure to maintain, under the guidelines, the same ratio between operating expenses and gross rents which prevailed on the average during the preceding five years. The Conciliation and Appeals Board is also authorized to permit additional rent increases upon the execution of building-wide major capital improvements.[23] The law and subsequent regulations issued by the Housing and Development Administration, give owners of non-controlled accommodations an option: either to join as members of a newly established real estate industry stabilization association, complying with its code and abiding by orders of the Conciliation and Appeals Board, or to subject their properties to existing rent control.[24]

The rationale to the enactment of the Rent Stabilization Law of 1969 was that "many owners" of non-rent-controlled accommodations took advantage of the housing shortage, as evidenced by the 1968 vacancy rate, and demanded "exorbitant and unconscionable rent increases."[25] While cases of "rent gouging" came to the attention of the public in 1968, and were documented in a special Report to the Mayor,[26] our findings cast grave doubts on the advisability and equity of the act in its present form for the reasons discussed below:

This study has demonstrated that average rent increases for the period 1964-1968 lagged behind increases in operating expenses, resulting in a stagnating rate of

return on property. Powerful market forces, excessive supply of non-rent-controlled housing in the early 1960's, leading to vacancy losses, inhibited landlords from raising rents to a higher rate, and thus resulted in a narrowing of the traditional spread between property returns and yields on corporate bonds. Significant rent increases were made possible only in 1968 as leases of a normal three-year duration, which were entered into at the height of the tenants' market in the early and mid-1960's, and at terms very favorable to renters, expired and were subject to renewals. Therefore, the 1968 increases should be evaluated in the context of the preceding half decade, and viewed as an adjustment reflecting an attempt to "catch up" with rising expenses, and to restore to a degree a narrowing spread between property returns and yields on alternative investments. Furthermore, there is no evidence that non-controlled rentals constituted an undue burden on tenants by the end of the period 1964-1968: contrary to the situation in the controlled sector, the rent-to-tenants' income ratio in the never controlled segment had not risen, remaining well below the 25 per cent level which is considered by many to be a proper "ceiling," if a household is not to spend an excessive portion of its budget on rent.

One should also be aware of the fact that increased revenues from a residential structure do not necessarily mean an undesirable "milking" of the property. It is

evidenced from our findings that landlords who were financially able were also financially responsible. Such realtors chose to spend a relatively high amount of discretionary expenditures per room, thus maintaining, and enhancing sound housing, which is without doubt a very desirable social goal in a city plagued with a housing shortage.

The shortcomings of the Rent Stabilization Law of 1969 are of an even more serious nature: paradoxically enough, the Act, in attempting to curb rents will probably cause undesirably high rentals in whatever future private residential construction might take place in New York City. We have seen that the real cause of high rents is a housing shortage (rents did not increase in 1965 and 1966, despite rising operating expenses, as they did in 1968 when a shortage of dwelling accommodations allowed them to rise). The Act, in discouraging future private construction, will help to perpetuate the housing shortage, thereby permitting very high rents on new housing--not subject to the RSL. Furthermore, landlords of these new properties will probably suspect that within a period of time their structures will also be subjected to some new limiting legislation (whatever its name), just as post-1947 construction was subjected to rent stabilization. Investors therefore, would not consider the prospects for capital gains on their properties to be bright; they would instead search for as high a current return as pos-

sible, through relatively high rents.

Traditionally, investment in real estate was motivated to a large extent by hopes for capital appreciation due to growing demand, and the ability of the property owner to adjust rents, thus reflecting the uninterrupted operation of the market forces. Experience gained in the two years in which the act has been in existence, shows that the Rent Stabilization Law of 1969 inhibits the freedom of the landlord to act in such a "conventional" fashion. The latest annual order issued by the Rent Guidelines Board allows for rent increases; but these were calculated mainly to cover increases in operating costs with only a limited adjustment to compensate for the fact that in the meantime, as the Board has stated, "returns on capital invested in similar long-term investments have shown dramatic rises, while rental residential property has been afflicted by a shortage of capital, available only at rates of yield much higher than those contemplated only a few years ago."[27] The extent to which the RSL circumscribes the ability of the owner of a property to act in response to market conditions, is further evidenced by a recent ruling of Conciliation and Appeals Board to the effect that rent increases permitted by the guidelines are not to be exceeded even at the mutual contractual agreement of landlord and tenant, and where the apartment in question may possess "unique characteristics."[28]

The "weakening definition of property,"[29] which

threatens the security of investment noted by Sternlieb, has been a serious factor deterring investment in residential real estate in New York City. Our written and oral communication with investors has established that they consider the Rent Stabilization Law of 1969 as further eroding their property rights over non-controlled rental housing which has been constructed in the post-war period in the belief that it will be exempt from rent controls. Such investors are not the equity investors solely (the landlords who traditionally invest only a small portion of the total amount required), but lenders as well, banks and other financial institutions which provide the major share of the necessary investment. A property return comparable to other alternative yields available, is a weighty criterion by which they measure the safety and the desirability of a proposed investment in real estate. Any legislation that interferes with the free movement of such a return, at a time when other yields are not similarly restricted, is likely to result in the channeling of badly needed funds away from housing.

The Rent Stabilization Law of 1969 thus emerges as a seriously flawed piece of legislation. Its motivation--prevention of "rent gouging"--is understandable, yet its long-run effect on the volume of residential construction in New York City may prove deleterious. Having established May 31, 1968 rents as a base, allowing for increases which are based mostly on subsequent changes in operating and

financing expenses, it has in effect disregarded the many cases where existing rents in mid-1968 were significantly depressed due to excessive vacancies in the early and mid-1960's. The RSL is regarded by realtors as a symbol of bad faith and broken promises on the part of public authorities, and this at a time when federal income tax reforms have made the holding of used real estate property less advantageous, thus reducing the opportunities of the original builder for a capital gain upon sale to a subsequent buyer.

In order to remedy the present situation, several public policy options are available. The options are not necessarily mutually exclusive; some of them could supplement others. The passage of any alternative legislation, however, is dependent upon public acceptability; "milder" proposals stand a better chance of passage. Nevertheless, a degree of political leadership and courage on the part of the public policy makers are a prerequisite for any meaningful reform.

As we have shown, fear and suspicion characterize the attitude of investors in New York City real estate in the aftermath of the RSL--a law which realtors are convinced is proof of untrustworthiness on the part of public authorities who had promised not to subject post-1947 residential housing to limiting rent laws. Realtors are therefore wary of undertaking new construction which,

though exempt from the present RSL, might become subject to future restrictive legislation. Such fears could be largely eliminated by New York State legislation, terminating the City's authority to extend rent controls to dwelling units that are not controlled at the present time.[30] Builders would thus be reasonably assured that any residential construction undertaken by them in the future will be free of hastily conceived and suddenly imposed new controls.

The RSL itself may be reformed through a gradual removal of classes of dwelling accommodations from the coverage of the law, similar to the exemption from rent-control of high rental apartments previously controlled. Upon further study, a formula may be devised that will take into account, prior to removal from rent stabilization, additional factors such as the number of persons per room, in order to discourage the occupation by relatively small households of unduly large apartments whose rents have been stabilized, to the detriment of apartment seekers such as large families, growing households, etc.[31]

The RSL may be further amended to allow a better reflection of the free market forces: tenants and landlords should be permitted to negotiate terms of renewal leases which may vary from the guidelines set-up by the Rent Guidelines Board, thus recognizing the unique features of a particular apartment, providing for "pass-along" of

expense increases, etc. Such terms may be invalidated in favor of the official guidelines should the tenant claim and prove that undue harassment by the landlord preceded their contractual agreement.

The RSL in its present form emphasizes "prevailing and projected" expenses as a guide to "the level of fair rent increases."[32] We have seen however, that the most important test of investment performance, is the rate of return generated by the property, as compared to returns on alternative investments. Admittedly, although the Law permits consideration of "other things,"[33] it may nevertheless be worthwhile to "spell out" in the Law returns on alternative investments as a major consideration in determining allowable maximum rent increases. Such a directive to the Rent Guidelines Board may serve to assure investors that the Law does not wish to shun traditional free market considerations.[34]

The most far-reaching alternative would be either an outright repeal of the Rent Stabilization Law of 1969, or a declaration of intent not to renew the Law upon its expiration on April 1, 1974. The probability of legislative passage of either of these alternatives is apparently dim, due to fierce opposition by politically powerful tenants' groups.

Admittedly, any move towards relaxation of rent legislation will require political leadership and courage of the

first order. However, a short-sighted public policy will only assist in perpetuating the housing shortage which has already assumed crisis proportions. In the final analysis, tenants no less than landlords will be the beneficiaries of a policy that will reverse the present state of affairs in which private unsubsidized residential construction in New York City has come to a standstill. There is indeed growing evidence that realtors will react positively to a meaningful reform of the Law, reactivating their investment plans for residential housing in New York City.[35]

2. The real estate tax. Special attention was paid in the present study to the real estate tax which is levied on residential housing as well as on other types of real property. Any consideration of future reform of the tax should take into account two basic facts:

(1) The tax is a major source of financing for the City of New York, as well as for any other municipality in the United States.[36] While having declined in recent years in its relative importance in the total financing of the New York City Expense Budget, the real estate tax is still the largest single item of revenue from within the City, $1.7 billion or 28.9 per cent of the total expense budget for the fiscal year 1968-69, and $1.9 billion or 28.9 per cent for the fiscal year 1969-70.[37] The tax is not expected to grow significantly in the 1970's as a

source of finance for the City of New York,[38] but with the growing fiscal needs of the City one could not expect significant reductions in it either, unless extremely large increases in federal and state aid were forthcoming in such forms as revenue-sharing, etc.[39]

(2) The real estate tax on housing is regressive. Our study--confined as it was to non-controlled properties--has shown that the tax occupies a higher percentage of the "rent dollar" among the lower priced dwellings. Several investigations have confirmed the regressive incidence of the tax, demonstrating that the burden of the residential real estate tax,measured as a percentage of the incomes of households, is higher for low-income families than for middle and upper-income families.[40]

The present situation,as we have seen, is such that, on the average, high rental apartments are burdened with a smaller real estate tax load, expressed as a percentage of total revenues, than lower rental apartments. To correct this regressive feature, it is suggested that <u>an examination of assessment rolls be undertaken in order to eliminate excessive underassessment of properties where it exists</u>. While property market values are to be determined as a multiple of the rent roll of a given structure, excessive underassessment exists when the ratio of the assessed value to the market value falls below the average ratio for the locality. Keeping in mind the needs of the City

in any given year for a specified amount of money to be provided through the real estate tax, any underassessment of a property means that the tax incidence will fall inequitably on those occupying other structures in the community, a phenomenon with undesirable socio-economic implications that should be corrected.

To further combat the regressivity of the real estate tax, one may have to search for new or little-tried solutions, that will of necessity arouse an intense political controversy. One possibility is that in the case of improved properties, the City of New York might examine the feasibility of a real estate tax directly levied on tenants rather thean on the owners of such residential properties.

The advantages of such a reform may be several: landlords would be freed of a major expense item, thus reducing significantly their fears of uncertain investment returns in the face of rising operating expenses. Instead of rent control and rent stabilization, that benefit the affluent as well as the needy, an element of selectivity would be introduced, allowing for progressive burdens rather than regressive ones.[41] Tenants may also be able to reap income tax benefits similar to homeowners and owners of cooperative apartments.[42]The City, on the other hand, would adjust the

tax rate in a progressive fashion from year to year, according to its budgetary needs. While serious administrative problems will undoubtedly arise, their solution may be facilitated by the fact that New York City residents are already required to file City personal income tax returns, which might be supplemented with a a real estate tax schedule.

Admittedly, the proposal is an unorthodox and untried one, and its implementation will require a detailed technical feasibility analysis. Questions may be raised, for example, as to collection methods, the legality of such a reform in the present framework of the State Constitution, state and local laws and the obligation of the City to its bondholders. A response to our inquiry along these lines at the Bureau of the Budget--which has already been giving some thought to similar ideas--indicates a preliminary assessment to the effect that the legal obstacles, to the extent that they may exist, are not insurmountable and the belief that no constitutional difficulties are involved in such a shift in the incidence of the tax.[43]

D. Concluding Comments : Recapitulation

1. Sensible public policy on housing in light of the present study. As this work progressed, it was heightened by an unusual sense of urgency, growing by the day. Editorials in the daily press and on the air waves, essays and articles in periodicals, studies commissioned by governmental agencies, all decried the expanding housing crisis afflicting New York City. The tumultuous public debate may have subsided somewhat, though not for long, but the need for a bold innovative public policy on housing remains.[44] The makers and formulators of public policy could either aim at "popular" solutions to achieve maximum electoral gain, or they may attempt to encourage more residential construction. The most effective way to accomplish the latter is by creating an atmosphere which is conducive to private unsubsidized housing activities on a large scale. It is in the final analysis the truly sensible public policy on housing.

Expectations for financial gain have traditionally been a powerful motivation for sizable private residential construction. A public policy which is based primarily on limiting rent legislation, as is the case in New York City, all but eliminates realtors' hopes for capital appreciation of their residential properties.

Such policy is therefore detrimental to the creation of an atmosphere which is conducive to private unsubsidized housing activities. The point is often made, however, that the public policy makers have an obligation to the community at large. They are called upon to preserve the interests of the tenants, the middle and low-income classes, no less than the narrow and specialized interests of a select and relatively few investors in realty. The question is raised: where would the masses be, what excessive rents will they have to pay, without protective legislation?

This acrimonious and perennially raging debate has conditioned us to consider the public policy issue in terms of irreconcilable differences, indeed a "tug of war" between renter and landlord, where the government can do no more and no better than provide a measure of legal protection to a constantly threatened tenantry. Yet, a dilemma still remains: are the tenants truly served in the absence of residential construction? According to the findings of this study, rents did not rise significantly when there was an abundant supply of dwelling accommodations in New York City in the early and mid-1960's. In other words, the interests of the renters may be better served by encouraging ample housing rather than by restrictive rent legislation. The latter may indeed accomplish the opposite of its declared goal: by reducing any future construction to the minimum, according to traditional eco-

nomic reasoning, this allows owners of such newly built accommodations, which are not covered by existing rent legislation, to charge higher rentals than they could have demanded had there been a larger supply of housing. These landlords may indeed be persuaded that it is incumbent upon them to charge the very highest of rents, since a current return is all they can hope for, because some future (even though presently unannounced and officially denied) rent legislation will severely curb any possibility of capital gains on their properties. The conclusion is thus inescapable that such legislation operates mainly against the interests of newly formed, young, expanding households which cannot find reasonably priced rental accommodations in the City. A policy that is designed to serve the public may therefore cause an exodus into the suburbs of young families who could contribute to the viability and vibrancy of the City.

Our study has further shown that landlords chose to invest in the repair, maintenance and upkeep of their non-controlled properties. This is positive conduct from the public point of view, and it indicates that the absence of very restrictive rent legislation does not necessarily mean "milking of properties" through high rents, but rather a "ploughing back" of a sizable share of the rent roll. Such a course of action is followed by a landlord who considers his property a profitable investment that should

be retained.

Our findings indicate that the attractiveness of investment in non-controlled rental housing in New York City has diminished during the period 1964-1968, when comparison is made with yields on alternative investments, such as corporate bonds. We have also established that during this period operating expenses rose faster than rents, while census data indicate that the percentage rise of the latter did not exceed that of tenants' incomes. These findings have compelled us to reject the equity as well as the wisdom of the Rent Stabilization Law of 1969 in its present form. They explain much of the rent increases of 1968, which prompted the enactment of the RSL, as an attempt by landlords to "catch up" with rising expenses, and to bolster faltering property returns. These findings do not provide support for the claim that the rent increases resulted in massive hardships to tenants.

The opposition expressed in these pages to the present Rent Stabilization Law of 1969 is thus shown to result directly from the findings of this study. It is not suggested,however, that the real estate industry is "free of all blame" in the present housing crisis. Other segments of the American economy have traditionally provided financial data, which were in many cases reliable and informative, be it on an individual, company by company basis, or on an aggregate basis through reporting by trade

organizations. Landlords, on the other hand, have been notoriously secretive and reluctant to divulge such data, thus helping to perpetuate, until recently, a state of almost utter ignorance, confusion and possibly myth in regard to the financial results of their operations. In addition, as many realtors will acknowledge, there are present amongst them some unscrupulous entrepreneurs who all too readily will engage--whenever the opportunity presents itself--in shadowy and unconscionable practices of "rent gouging," rapid turnover of properties in order to generate quick capital gains, etc. Such anti-social behavior, even if only occasional, stigmatizes an industry and contributes to a public outcry resulting in limiting legislation. The real estate industry would be well-advised, therefore, to allay public fears by: 1) initiating an orderly and wide flow of financial data, and 2) expressing readiness to vigorously self-regulate its members in order to prevent abuses should rent legislation be relaxed. Discussions with realtors have provided this writer with the impression that the industry is indeed ready for such a step. Furthermore, there are reasons to believe that should the proposed relaxation take place, the likelihood of "rent gouging" would be reduced due to both increased construction, as well as the realization by landlords that abuses might trigger the reimposition of limiting legislation. The thrust of our argument, how-

ever, is not that owners and managers of rental housing are "free of all temptation" to engage in unsavory practices. Public authorities should continuously monitor the operation of the rental housing industry because of its vital importance to the welfare of the community. The flow of financial data suggested above is, without doubt, a prerequisite to such monitoring by government. However, the most effective and lasting means of combatting and dampening undue rent increases is through the encouragement of large-scale housing construction.

2. Future studies suggested by complexities of the housing problem. The key to the housing crisis afflicting New York City is not within easy reach. The housing malaise is multi-layered; it mercilessly attacks the poor, yet the upper-middle class is not exempt from its grip either. While recent studies have added substantially to our understanding of the problem and its roots, there is still a pressing need for additional data. Little is known, for example, on the true extent and nature of the massive abandonment phenomenon which, in New York City, has consumed seemingly sound, as well as deteriorating housing. The need for a study of the feasibility of a reform of the real estate tax has been mentioned earlier. The possibility of further use of tax abatement in order to lower rentals should be examined in conjunction with an investigation into the availability of alternative

sources of finances for the City of New York. There is also a need for comparative studies of similar classes of rental properties in various American cities. Such studies will enable us to evaluate the effect of varying public policies, as well as other factors, on the supply of housing, its maintenance, and its rent levels. Some of the variables that deserve investigation were mentioned earlier: zoning and code enforcement policies, site, construction and finance costs, as well as patterns of change in population, employment and income.

Studies to date have concluded, however, that what New York City needs is a revival of expectations in the future of private investment in residential construction. It is to this end that the City's public policy on housing should be directed.

NOTES TO CHAPTER VI

[1]Using Census data, Kristof arrived at a net decline of 21,200 units in the New York City housing inventory between January 1, 1965 and January 1, 1968. Frank S. Kristof, "Housing: Economic Facets of New York City's Problems," in Agenda for a City, p. 308.

[2]A recent flurry of articles in the press attests to a growing public awareness of the acuteness of the problem. See, for example, "Public Sector Failing to Close Housing Gap," New York Times, Sec.8, March 14, 1971, p. 1R.

[3]This approach has actually been mandated by federal legislation. Included in the Housing Act of 1949 is a declaration of national housing policy which states the "goal of decent home and suitable living environment for every American family," but "this goal," according to the Housing and Urban Development Act of 1968, "has not been fully realized for many of the Nation's lower income families," and therefore "the highest priority and emphasis should be given to meeting the housing needs of those families for which the national goal has not become a reality." See Committee on Banking and Currency, House of Representatives, 91st Congress, 1st Session, Basic Laws and Authorities on Housing and Urban Development, pp. 1 and 3 respectively. For detailed listings of federal housing programs and activities, see the First Annual Report on National Housing Goals and the Second Annual Report on National Housing Goals, both titled, Message from the President of the United States, (Washington, D.C.: Government Printing Office, 1969 and 1970 respectively).

[4]James Gillies, who evaluated federal housing policies arrived at similar conclusions. According to Gillies, "the most successful housing programs in the United States have been associated with the financing of home-ownership rather than rental housing ." Furthermore, legislation has been successful

> "(1) when it has operated in conjunction with elements within society--e.g., commercial banks, life insurance companies, et. al.--and (2) when it has been designed to supplement the operations of the free market price system."

James Gillies, "The Future of Federal Housing Policies in the United States," The Economic Problems of Housing, pp. 140 and 142 respectively.

[5]Welfeld, op. cit., p. 32.

[6]The process has recently been documented in the study of sequences of moves which are originated by new construction: in 17 geographical areas in the United States (representing New York and other standard metropolitan statistical areas with a population of 200,000 or more in the central city), it was established that "on the average for every 1,000 new homes about 3,500 families are able to move" (3.5 positions average length of sequences of moves), and that "about 9.4 per cent of the movers will be poor." A major conclusion of the study bears repetition:

> " The working of the market for housing is such that the poor will benefit from any actions which increase the supply in the total market. There is a natural tendency for someone who is concerned with the provision of housing for the poor to take a direct approach.....The evidence in this research is that the direct approach is not the only approach which will be effective."

John B. Lansing, Charles Wade Clifton, and James N. Morgan, New Homes and Poor People--A Study of Chains of Moves, (Ann Arbor, Michigan: Institute for Social Research, The University of Michigan, 1969), pp.66 and 68 respectively.

For applicability to New York City, see Frank S. Kristof, "Housing Policy Goals and the Turnover of Housing," Journal of American Institute of Planners, (August, 1965),pp.232-245.

It should be clearly understood that this discussion is not meant to detract from the urgency and the value of a vigorous and continuous program of construction of public and publicly assisted new housing for low and middle-income families, thus providing them with the opportunity to move into decent and newer accommodations.

[7]Indicative of the new awareness is the conclusion by Rand that "large quantities of private capital must be drawn back into rental real estate in New York City if any serious program of housing betterment is to succeed." Rental Housing in New York City, p. VII.

[8]Ibid., p. IX.

[9]Sternlieb, Urban Housing Dilemma, p. 48.

[10]According to one estimate, the number of whites has declined by 516,000 between 1960 and 1968, while the number of non-whites has increased by 466,000 and the number of Puerto Ricans rose by 252,000 during the same period. Emanuel Tobier, "Economic Development Strategy for the City," Agenda for a City, p. 36.

[11]Ibid., p. 42.

[12]James R. Dumpson and Paul Schreiber, "Welfare and Income," Agenda for a City, p. 88.

[13]Kristof, "Housing: Economic Facets of New York City's Problems," p. 345.

[14]See "Blue Ribbon Developers Assert: 40,000 NYC Suites Could Get Underway Now," Apartment Construction News, September, 1970, p. 1. Citation was based on an interview with a panel of spokesmen for the Associated Builders and Owners of Greater New York, Inc., a trade organization of some 40 member-firms of developers of multifamily housing in all price ranges.

[15]Computation was based on the following index numbers (1913 is the base year): 1965-756; 1969-927; 1970-1001; 1971-(projected) 1173. See Engineering News-Record, Vol.185, No. 25, December 17, 1970, p. 28.

[16]Kristof, "Housing: Economic Facets of New York City's Housing Problems," p. 323.

[17]Rental Housing in New York City, p. VII.

[18]Ibid., p. 29.

[19]Sternlieb, Urban Housing Dilemma, pp. 47, 48.

[20]Ibid., p. 50.

[21]The 1968 figures were: total number of housing units-2,798,000; renter-occupied units-2,122,000; owner-occupied units-676,000; controlled units-1,280,000. U.S. Bureau of the Census, New York City Housing and Vacancy Survey, 1968, cited by Niebanck, op. cit., p. 13.

[22]RSL, §§yy51-5.0 d (1) and (2).

[23]Ibid., §§yy 51-6.0 c.

[24]Ibid., §§yy 51-4.0 a and Housing and Development Administration, Rent Stabilization Regulations, Section 3, August 7, 1969 (as amended on May 29, 1970).

[25]RSL, §§yy 51-1.0.

[26]Report to the Mayor on an Investigation into Rental Increases in the Non-Controlled Housing Market.

[27]Rent Guidelines Board, Order Number 2, July 1, 1970 trough June 30, 1971.

[28]Conciliation and Appeals Board of the Rent Stabilization Association, Opinion Number 661, September 8, 1970.

[29]Sternlieb, Urban Housing Dilemma, p.50.

[30]A similar proposal was included in a recent Special Message to the Legislature by Governor Nelson A. Rockefeller, April 27, 1971. The message also called for termination of the City's "authority to impose stricter controls on units already controlled." State of New York, Executive Chamber, Nelson A. Rockefeller, Governor, press release, (April 28, 1971), (mimeographed). See also "Rockefeller Urges Eased Rent Curbs," New York Times, April 28, 1971, p.1.

[31]Governor Rockefeller's proposal (see note 30) also offers a gradual plan, through the decontrol (and destabilization), of any apartment voluntarily vacated by a tenant.

[32]RSL, Syy 51-5.0 d.

[33]Ibid.

[34]A caveat is due here: the Law should not spell out a particular permissible return, for this would establish a ceiling on returns similar to existing rent control legislation, hence further discouraging potential investors. I gratefully acknowledge my indebtedness for this point to Mr. William H. Shron, CPA, a member of the Conciliation and Appeals Board of the Rent Stabilization Association.

[35]It is interesting to note in this connection, the reaction of builders to the recently announced rent reform bill of Governor Rockefeller (see notes 30 and 31 above). In declaring their support for the Governor's proposal, the Council of Builders and Owners Association of New York stated:

> "We are prepared to embark on a multi-billion-dollar building program to help bring this city's housing back to life. We've been lured. Now, it's up to the Legislature to decide whether New York will have its housing renaissance."

Council of Builders and Owners Association of New York, press release, (May 6, 1971) (mimeographed). See also, "Group Sees Housing Spurt If Rockefeller's Plan Wins," New York Times, May 7, 1971, p. 24.

Discounting its propagandistic and self-serving element,

the announcement by the Council is of significance nevertheless, because its six-member association represent builders who have constructed a major part of the post-World War II housing in the Greater New York area. The associations are: Associated Builders and Owners of Greater New York, The Long Island Builders Institute, Builders Institute of Westchester and Putnam Counties, New York City Builders Association, The Investing Builders and Owners Association for New York, and The Building Industry League.

[36] In many urban areas residential property constitues about half of the total tax base. National Comission on Urban Problems, op. cit., p. 358.

[37] Based on an analysis by Dick Netzer who used the annual reports of the New York City Comptroller. See **Agenda for a City**, p. 652. It is interesting to note, however, that in the fiscal year 1959-1960 the real estate tax financed 44.0 per cent of the total expense budget of the City of New York, and in the fiscal year 1964-1965 the tax amounted to 39.2 per cent of the expense budget. While the relative importance of the tax has clearly diminished, the role of state and federal aid has gone up from 21.2 per cent in the fiscal year 1959-1960 to 25.3 per cent in the fiscal year 1964-1965 and 42.0 per cent in the fiscal year 1968-1969. There was, however, a slight decline to 40.7 per cent in 1969-1970.

[38] Ibid., p. 656.

[39] For suggestions in this direction see Chapter IV: State-local actions toward better urban financing, and Chapter V: Overhauling Federal aid for urban governments. A revenue-sharing plan, in National Commission on Urban Problems, pp. 362-383.

[40] For a detailed treatment of the topic see "The Incidence of the New York City Tax Stystem" by Alan D. Donheiser, Financing Government in New York City (New York: Graduate School of Public Administration, New York University, 1966), pp. 171-180.

[41] While the suggestion made here is as yet an untried one, a similar realization that the real estate tax is a regressive one, prompted the State of Wisconsin to provide "relief to those who have inordinately high property tax burdens (or rent in lieu of property tax) in relation to their household incomes." The Wisconsin program is limited to the aged and the poor (those who are 65 years of age or older and have less than $3,500 in household income.) The program possesses two interesting features from our

point of view (1) it applies to both homeowners and renters, (2) relief is administered through the state individual income tax law. It has been noted that the program "has transformed the regressive property tax into a proportional tax for these selected low-income households." Kenneth E. Quindry and Billy D. Cook, "Humanization of the Property Tax for Low Income Households," National Tax Journal, XXII, (September, 1969), pp. 358-and 361 respectively. The national attention attracted to the Wisconsin program is evidenced by its extensive discussion in publications such as the following: Advisory Committee on Intergovernmental Relations, State & Local Finance, Significant Features 1966 to 1969, (Washington, D.C.: Government Printing Office, 1968), pp. 4 and 5.

[42] As pointed out by Netzer, the present working of the United States tax law is such as to substantially discourage consumption of rental housing. Richard Netzer, "Housing Taxation and Housing Policy," The Economic Problems of Housing, p. 134.

[43] Per oral discussion with personnel of the Bureau of the Budget and written communication dated February 1, 1971 from Mr. Jonathan Weiner, Senior Program Planner, Office of the Mayor, Bureau of the Budget. Mr. Weiner writes:

> "...we have been giving thought to a possible shift of the legal incidence of the real property tax from landlord to tenant in the case of residential buildings.
>
> Our assessment of the legalities--which I must stress is still preliminary--is that such a shift in incidence will, of course, require changes in State law, but would not we believe violate any provision of the State Constitution."

[44] Even those who believe and claim that the real solution to New York City's housing crisis lies in massive financial help from the Federal government, will have to insist nevertheless that wise public policy on housing should start at the local level. The City's supplications to Washington will sound hollow, if local government has not done all that is within its power to alleviate the pressing shortage. This point has been made by Pechman who stated, "I doubt that the Congress would want to enact a rent subsidy merely to bail out New York City and its misguided rent control policy." In a letter to this writer, dated November 4, 1969, from Joseph A. Pechman, Director of Economic Studies, The Brookings Institution.

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