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Housing Market Spillovers

Evidence from the End of Rent Control in Cambridge, Massachusetts

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An essential input in the design of housing policy is a rigorous understanding of whether and how much the attributes and actions of neighbors affect surrounding people and properties. While the relevance of such spillovers appears intuitive—spend time with your local real estate agent and he or she will talk about how a property’s value is affected by its neighborhood—credibly identifying the existence of these spillovers and quantifying their magnitude poses a significant empirical challenge. The difficulty stems from the fact that the characteristics of a neighborhood—who lives where, the quality and quantity of housing, the levels of local public goods and amenities, and what prices prevail—all interact with each other to determine the housing market equilibrium. Empirically, it poses the proverbial chicken-and-egg problem: is a neighborhood desirable because good neighbors live there, or do good neighbors live there because it is a desirable neighborhood?

Our research assesses the importance of housing market spillovers empirically by exploiting an unusual large-scale policy change that shook up neighborhoods in Cambridge, Massachusetts, allowing us to see how the housing market responded. From 1970 through 1994, rental units in Cambridge built prior to 1969 were regulated by a rent control ordinance that strictly capped rent increases and tightly

restricted the removal of units from the rental stock. The legislative intent was to provide affordable rental housing, and, although maintenance and amenities in controlled units tended to be subpar, controlled units typically rented for over 40 percent longer than nearby noncontrolled properties (Sims 2007). The policy change that provides the natural experiment for our study is the swift and largely unanticipated elimination of Cambridge’s rent control law by a statewide ballot initiative. In November 1994 the Massachusetts electorate passed a referendum to outlaw rent control by a narrow 51 to 49 percent margin, with nearly 60 percent of Cambridge residents voting to retain the rent-control ordinance. Because the rent control ordinance applied only to a fixed, non-expanding set of residential units, controlled and never-controlled units stood side by side on the eve of rent-control removal, offering a tight temporal and geographic framework for assessing the impact of the law.

Using the end of rent-control as a looking glass into the workings of Cambridge’s housing market, we can determine not only the direct effect of rent control-elimination on formerly rent controlled properties but also the extent to which rent control affected the desirability of neighborhoods. In practical terms, we calculate a rent-control exposure measure for each residential unit, quantifying the fraction of nearby units that were subject to rent control as

of 1994. Although roughly a third of residential units were controlled prior to elimination, this fraction frequently exceeded 60 percent in neighborhoods that had older housing stocks and a substantial share of renters at the time of rent control's enactment. Comparing the post-rent-control price appreciation of units that were relatively more and less exposed to formerly controlled neighbors, we find robust evidence for the existence of large spillovers. Our bottom line estimate is that the end of rent control added \$2 billion to the value of the Cambridge residential housing stock over the ensuing decade following rent-control removal.

Why did the end of rent control spur such dramatic appreciation? We distinguish two channels through which rent decontrol may affect the market values of residential properties. The first, which we term the direct effect, reflects the newfound ability of formerly rent controlled landlords to charge market rents. Even absent any spillovers, rent control removal should directly raise the ownership value of formerly controlled properties by uncapping rents and increasing the returns to landlord investments. Of course, this primarily reflects a transfer from future renters to landlords rather than an increase in the economic value of housing services produced.

The second channel, which we term the indirect effect, encompasses the complementary mechanisms through which rent decontrol makes surrounding properties more attractive. As owners renovate and modernize decontrolled units, they improve the appearance of the neighborhood and increase the value of properties used as comparables in valuing nearby real estate. Others may value living near the more affluent residents moving into decontrolled properties. The resulting gentrification can bring other neighborhood amenities such as reduced crime. Property owners may make further investments in both decontrolled and never-controlled units in response to this neighborhood upgrading and as local income levels rise. These indirect channels, which increase the economic value of housing services, will raise the market price of *both* formerly controlled units *and* of never-controlled units situated in rent-control-dense neighborhoods.

Our main estimates imply that rent-controlled properties were valued at a discount of about 45–50 percent relative to never-controlled properties with comparable characteristics in the same neighborhoods and that their assessed values rose by 18–25 percent relative to never-controlled properties following rent decontrol. This differential appreciation should primarily reflect the direct

effect of rent decontrol on the market value of formerly controlled units generated by the potential for owners to charge market rents, the option to convert rental units into condominiums, and the flow of returns from associated capital investments.

Distinct from the direct effect of decontrol, the indirect channel may affect both decontrolled and never-controlled properties by increasing the desirability of the neighborhoods in which they are located. By one measure, over the 10 years following decontrol, residential property values in neighborhoods with more rent control (at the 75th percentile of our rent control-intensity measure) appreciated around 13 percent more than did properties in less rent-control-intensive neighborhoods (at the 25th percentile of exposure). Notably, the differential appreciation of properties in rent-control-intensive locations was equally pronounced among decontrolled and never-controlled units, suggesting that rent-control removal spurred overall gains in neighborhood desirability.

While we cannot cleanly separate the indirect effect into its constituent components (investment, resident composition, neighborhood amenities, and their complementarities), available evidence suggests that each channel was relevant. Because Cambridge's Rent Control Board was unlikely to grant rent increases following property improvements, it was widely perceived that rent control muted owners' incentives to maintain and improve controlled properties. Consistent with this view, Sims (2007) finds that chronic maintenance problems—such as chipped or peeling paint—were more prevalent in controlled than in noncontrolled units, and that the differential fell substantially with rent control's elimination.

The end of rent control also spurred substantial tenant turnover. Cambridge's rent-control law was intended to enable less affluent tenants to reside in units that would command high rents under a market allocation, particularly in the dense neighborhoods proximate to Cambridge's major universities, commercial centers, and transportation hubs. While no formal mechanism allocated controlled units to low-income households, limited quantitative evidence indicates that less affluent residents and students were over-represented in controlled units, though at least some were also occupied by wealthy professionals. We show that exit rates from formerly controlled units spiked in the years following decontrol. And given the substantial accompanying increases in rents, it is likely the new renters were significantly more affluent than the tenants they replaced.

Consistent with the end of control inducing a wave of new investment, we find that aggregate annual permitted building expenditures increased substantially among both houses and condominiums after 1994, rising from \$21 million per year between 1991 and 1994 to \$45 million per year between 1995 and 2004. Still, the *total* value of Cambridge residential investments in these 10 years was less than one-quarter as large as the estimated increase to Cambridge residential housing values induced by rent-control removal, suggesting that other neighborhood changes were more important drivers of the post-1994 rise in the market value of never-controlled properties.

Combining the direct effect of rent decontrol with these mutually reinforcing indirect effects, we estimate that the total impact of rent-control removal on the value of Cambridge's housing stock was quantitatively large, contributing \$2 billion to the \$7.7 billion that Cambridge residential property appreciated in the decade between 1994 and 2004. Of this total effect, only \$300 million was attributable to the direct effect of decontrol on formerly

controlled units, while \$1.7 billion was due to the indirect effect. The majority of this indirect effect (\$1.1 of \$1.7 billion) in turn stems from the differential appreciation of never-controlled units. In net, our estimates imply that more than half (55 percent) of the capitalized cost of rent control was borne by owners of never-controlled properties, illustrating both the importance of spillovers in housing markets and the potential unintended side effects of price ceilings.

NOTE

This Research Brief is based on "Housing Market Spillovers: Evidence from the End of Rent Control in Cambridge, Massachusetts," David H. Autor, Christopher J. Palmer, and Parag A. Pathak (2014), *Journal of Political Economy*, 122, no. 3, (June 2014), pp. 661–717.

All works cited are provided therein.