BALANCED SPACE RENT GUIDELINES

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January, 2010

Executive Summary

There are more than 5,700 mobilehome parks in California with a total of some 380,000 spaces. Mobilehomes in mobilehome parks house just over a million Californians.

A clear majority of California's mobilehome spaces are not price-regulated, while 39% of mobilehome spaces in California are rent-controlled. A small but growing number of mobilehome spaces are subject to alternative rent stabilization measures.

Calls for rent control arise from time to time in unregulated jurisdictions. On the other hand, rent controlled jurisdictions from time to time seek to find a way out of rent control. At one time, rent control was the only available option. In recent years, communities throughout California have been experimenting with cooperative alternatives, including targeted subsidy programs, model lease programs, and memoranda of understanding (MOU) programs.

In crafting rent stabilization programs, whether traditional or alternative, communities should attempt to strike a balance between the rights and needs of park owners and the rights and needs of mobilehome residents. Too often, mobilehome space rent issues are driven by local politics, and too often the outcomes of local political decisions are irrational and divisive.

This report sets out principles and guidelines intended to assist communities in crafting balanced solutions to space rent questions when they arise.

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INTRODUCTION

Understandably, mobilehome park residents experience large and sudden space rent increases as burdensome. When such increases occur, residents often seek political solutions, including rent control. But in jurisdictions that have adopted rent control programs, space rents are often controlled far too strictly, causing significant dislocations in the rental market that can lead in time to park deterioration, lengthy and expensive litigation, and a loss of civic harmony. Jurisdictions that have adopted rent control programs therefore often seek a better way to address insecurity about space rent increases.

This report stands for the principle that balanced space rents – rents that are neither too high nor too low - can and should be achieved through a healthy, freely functioning rental market and, when necessary, through policies and programs established through a consensus-building process involving all stakeholders, and through adherence to the guidelines spelled out in this report.

ALTERNATIVES

It was thought at one time that the only way to prevent large, sudden mobilehome space rent increases was to enact rent control. Many space rent ordinances were enacted in California cities and counties in the late 1970s and early 1980s. Since that time, however, it has come to be understood that rent control is inflexible, subject to political pressure, and usually too restrictive, and that for these reasons rent control routinely causes the development of major imbalances in the mobilehome space rental market. Many cities and counties are therefore experimenting with less rigid alternatives including memoranda of understanding, model leases, and subsidy programs.

A memorandum of understanding (MOU) is an agreement negotiated between park owners and residents, often with the assistance and oversight of the local municipality, that sets boundaries on space rent increases. Under a typical MOU it would be impossible for a park owner to impose large, sudden space rent increases. A typical MOU, on the other hand, would provide for annual space rent increases to compensate for inflation and for the pass-through of exceptional expense increases. Memoranda of understanding are usually accompanied by a model lease that is signed by park owners and residents participating in the MOU program.

The pressure for rent control often derives from the fact that less fortunate community members have a hard time paying their space rent. But rent control will not help very low income residents because rent control cannot lower space rents and because even rent-controlled space rents will continue to rise over time as operating and maintenance expenses increase. A subsidy program targeted to the lowest income residents will, on the other hand, be of genuine assistance to these residents, lowering space rents significantly and allowing very low income residents to remain in the community.

THOUGHTS ON "LARGE AND SUDDEN" SPACE RENT INCREASES

If large and sudden space rent increases follow a period in which space rents did not increase, or increased by less than inflation, the "large and sudden" increases may be perfectly reasonable. But they will not be seen that way. Residents don't like space rent increases. They especially don't like large and sudden space rent increases. Residents cannot be expected to know the history of space rents or to do the math that might justify space rent increases.

So large and sudden space rent increases are not a good idea, even when justified. At a minimum, any park owner contemplating large space rent increases should consult thoroughly with residents ahead of time, explaining in detail the need for increases, so that residents can make the budget adjustments that such increases would require.

Consider food, for example. It seems that a loaf of bread gets more expensive every year. Who would have imagined several years ago that we would be paying $3 to $5 for a loaf of bread today? If the bakers and grocery stores had kept bread prices under a dollar for the intervening period and then raised the price of bread to $5 or even $3 all at once, consumers would have been upset. There would be calls for regulation of bakers and grocery stores, no doubt.

Needless to say, bakers and grocery stores do it incrementally. We don't notice increases of $0.20 or $0.40. In any case, we don’t contact our congressman or city council person and demand regulation. So bread (and most other consumer goods) remain unregulated, despite the fact that their prices rise from time to time.

Park owners need to take heed. It is problematic when park owners keep space rents unrealistically low and then increase rents suddenly. Space rents should be raised in keeping with inflation every year. Failing to do this stores up trouble for the future – trouble for the park owner who won't have sufficient funds to maintain the park properly and trouble for the residents who may be faced with large and sudden space rent increases down the road.

MARKET IMBALANCE

One indication that the mobilehome market is out of balance is that the values of mobilehomes increase excessively when space rents are controlled too tightly. Through a process that economists call “capitalization”, rent discounts become embedded in the value of mobilehomes. Here is how capitalization works in the mobilehome context:

There are two main components to the cost of mobilehome housing - space rent and the cost of the mobilehome itself. Prospective park residents are willing to pay for this combination amounts determined by the housing market generally. If space rents are constrained to amounts below market, buyers will be willing to apply the discount to the purchase of the mobilehome. If, for example, space rent is discounted by $200 a month, the value of the mobilehome would, on average, increase by something like $30,000.[1] A mobilehome with intrinsic value of, say, $40,000, would sell in such a community for $70,000. The $30,000 extra is known as the “rent control premium”.

But if the buyer pays 8% interest on his or her mortgage, the rent control premium will involve additional mortgage interest of $200 per month, offsetting the rent discount exactly. This is what has been found by robust research into these questions: mobilehome values increase to compensate for space rent decreases, so that the cost of housing is no less to new residents.[2]

Meanwhile, the selling mobilehome owner makes a windfall gain that he didn’t earn and the mobilehome park owner suffers a continuing loss of the income he needs to maintain the park and as a return on his investment. Having enjoyed a rent discount for the time he lived in the home, the departing homeowner enjoys an unearned boost in the value of his home. But the park owner endures a double loss – the monthly loss of the rent discount and a capital loss because the value of the park is degraded.

This is artificial and unbalanced. The selling homeowner makes a windfall to which he has no right. The park owner is forced to accept a loss that makes continued provision of park services difficult or impossible. The incoming homeowner pays less for the rent but more for the home, so there is no increase in affordability over all.

The guidelines set out below are designed to prevent or resolve the market imbalances caused by restrictive rent control programs.

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[1] $200 a month * 12 months / cap rate of .08 = $30,000.

[2] See, for example, Quigley, John, “The Economics of Mobile Home Rent Control: A Case Study of Goleta, California”, August 11, 2004: “ Every dollar of mandated rent reduction leads to a one dollar increase in carrying costs for mobilehome owners” (page 28).

FAIR RETURN

Virtually every mobilehome park rent control ordinance in California says that rent control is intended to prevent excessive space rent increases and at the same time ensure that park owners can achieve a fair return on investment.[3] Since these two principles have opposite impacts – one pushing for lower space rents, the other pushing for higher space rents – there is inherent tension between them. It is not easy to draw the line between too little and too much in this context. It is not impossible, however. This report sets out and explains rules (guidelines) that allow the satisfaction of both principles simultaneously.

GUIDELINES FOR BALANCED SPACE RENT INCREASES

1. Space rents must be allowed to increase at the inflation rate.
2. Capital improvement expenditures must be reimbursed by appropriate rent increases.
3. Property tax increases and other new governmental fees must be covered by pass-through mechanisms.
4. Space rents must be allowed to readjust to market on vacancy.

If these guidelines are not followed, controlled rents will tend to fall further and further behind market rents. This wedge will cause the values of mobilehomes to rise excessively and the values of mobilehome parks to fall or stagnate. This dynamic creates tensions that are divisive and unnecessary, and leads to excessive litigation. Instead, communities can satisfy both principles simultaneously by adopting programs preventing excessive rent increases while allowing park owners a fair return.

If these guidelines are followed, the outcome will be favorable for residents, for park owners, and for the community. Sudden or excessive rent increases will be prevented. Park owners will achieve a fair return. Management will have sufficient funds to cover capital improvements and property tax increases. Parks will tend to be well-maintained. Parks and mobilehomes will both fluctuate in value with the housing market generally. There will be no cause for litigation.

These guidelines apply under model lease / memorandum of understanding arrangements as well as under rent control programs.

[3] If an ordinance fails to articulate the fair return principle, it is assumed to be there by operation of law.

Here is the rationale behind each of the four guidelines:

1. Rents Must Be Allowed to Increase at the Inflation Rate. This principle should not be controversial. On average, prices increase at the inflation rate. If rents also increase at the inflation rate, the real (inflation-adjusted) value of rents stays precisely the same over time and rents comprise the same percentage of the household budget. Important economic quantities are often indexed to inflation, meaning that they increase according to increases in the consumer price index (the CPI). Social Security payments, for example, are indexed to the CPI. Union contracts, teachers' salaries, and pensions are often indexed to the CPI. Some rent control advocates have argued that real estate is somehow different – that there is no need for rents to increase at the inflation rate.[4] But this view is incorrect. Rents increasing at anything below the inflation rate cannot possibly provide park owners a fair return.[5]

2. Expenditures on Capital Improvements Must Be Reimbursed by Appropriate Rent Increases. Park owners are faced with major capital expenditures periodically. Minor capital expenses may be covered by the rents in effect, but major capital costs are not commonly covered. The completion of major capital improvement projects must therefore be accompanied by space rent increases. There is no other way that they can be paid for. If capital costs cannot be covered by rent increases (if the costs cannot be "passed through" to the residents who will enjoy the benefits), park owners may not be able to undertake improvements that will keep the park running smoothly. Services will decrease. Parks will deteriorate. Eventually, parks may have to close. To prevent these outcomes, it is important that there be a mechanism by which major capital costs can be paid for over time through moderate space rent increases.

3. Property Tax Increases and Other New Governmental Fees Must Be Covered by Pass-Through Mechanisms. Proposition 13 keeps property taxes relatively low during one ownership but allows property taxes to increase at the time the property is sold. Under Proposition 13, property taxes increase by 2% per year, but rents, expenses, and values all increase at something close to the inflation rate, which has averaged 4% per year over the past two decades. Property taxes therefore decline as a percentage of total expenses during an ownership. Depending on the length of ownership, property taxes can then double or triple at time of sale. These increases, like other new governmental

[4] See, for example, Baar, Kenneth, "Fair Return Standards Under Mobilehome Park Space Rent Controls …", Real Property Reporter, Vol. 29, No. 5 (September 2006), p. 341.

[5] See St. John, Michael, "Fair Return and the California Courts", St. John & Associates, 1993.

fees, are not covered by the rent schedule in effect at time of sale. For this reason, space rent increases to cover increased property taxes must be allowed.

4. Space Rents Must Be Allowed To Readjust To Market On Vacancy. There are two forms of rent control: "vacancy control", and "vacancy decontrol". Under vacancy control, space rents stay the same when a mobilehome is sold to a new resident. Under vacancy decontrol, space rents may adjust to market on vacancy. When space rents are controlled on vacancy there is no way equilibrium can be restored. If controlled space rent increases are too low, vacancy control will leave a permanent wedge in the system, preventing space rents from returning to balance.

THE FAIR RETURN PRINCIPLE

There has been much debate over the years in the California legislature, in city and county councils, and in state and federal courts, about what constitutes a fair return on investment in a rent control context. The debate, in California especially, has been much influenced by the opinions of rent control advocate Kenneth Baar. Dr. Baar has written extensively about rent control, has advised many California cities and counties about rent control programs, and has been an expert witness in most of the key California rent control lawsuits for almost 30 years. Being untrained in economics, however, Dr. Baar doesn't understand real estate economics or the economic impacts of rent control.[6] His views about fair return under rent control are therefore incorrect.

Baar's first mistake impacts Guideline 1. Baar has for years been telling cities and courts that controlled rents don't have to increase at the inflation rate because free market rents don't increase at the inflation rate. As early as 1983, Baar wrote that

> "*During the past seventy years, United States rents have increased at an average rate of approximately two-thirds of the average inflation rate …*"[7]

In making this statement, Baar was relying on national CPI statistics, a conceptual error. Average rents across the entire country are useless for rent control analysis because rental housing and mobilehome spaces can only be marketed locally. What rents may be in Anchorage or New Orleans is irrelevant to rents in San Francisco or Modesto.

[6] In recorded testimony, Baar has explained that he is "self-taught" in the field of economics.

[7] Baar, K. "Guidelines for Drafting Rent Control Laws: Lessons of a Decade", Rutgers Law Review, Vol. 35 (Summer, 1983), p. 740.

Also, Baar didn't notice, or didn't mention, that the outcome depends critically on the time period chosen. While rents lagged inflation in the San Francisco Bay Area in the 1913 to 1982 time period just as they did in the national average that Baar used, S.F. Bay Area rent increases exceeded inflation increases in the period 1919 to 2009.[8] Rents lagged inflation in the period 1914 to 1939, but rents rose more than the CPI in the period 1939 to 2009. Rent increases tend to lag inflation in times of high inflation and exceed inflation in time of low inflation or deflation. Overall, one can fairly say that rents have tracked inflation closely (albeit cyclically) in local California housing markets over the past century.[9] Baar used the wrong index and the wrong time period and therefore reached the wrong conclusion.

Any economist would know that Baar could not be right about rents not keeping up with inflation. If free market rents increased by two-thirds of the CPI, rents would have decreased steadily, relative to inflation, for the past 100 years. If that really happened, housing would now comprise 10-20% of renters' household budgets instead of 30-50%. The Section 8 program would be unnecessary. There would be no homelessness. But Baar, not having economic training or intuition, hasn't looked further than his original, meaningless computation.[10]

More recently, probably because rent increases have kept up with or exceeded CPI increases in many markets in recent years, Baar mentions less often that free market rents don't keep up with inflation, but he has nowhere retracted his 1983 pronouncement.[11] Instead, Baar today relies on another mistaken idea – his belief that there is something different about investments in real estate that provide free market investors with extraordinary returns and that allow investors in rent controlled jurisdictions to make a fair return while rents are increasing at less than the CPI.

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[8] There was a kind of rent control during World War I that caused rents to remain stable for the duration of the war. Rents nationwide rose during those five years by just 4.8%. Prices, however, rose during the war years by 65%.

[9] This topic is treated in detail in St. John, M., "Fair Return and the California Courts", Section 2.

[10] Baar, an attorney and city planner, has been hired by many California cities and counties to draft rent control ordinances and to advise cities and counties about rent stabilization policy despite his lack of training in economics. The judge in a recent lawsuit had this to say about Baar's qualifications: *"…what Dr. Baar is qualified to opine on are institutional matters. That is, how public policy has been applied in the housing area and specifically with reference to this case, mobile home housing. It does appear that he lacks the background, training, and expertise to permit him to opine on the economic consequences of these policies. But he is qualified as one who can describe these policies, how they've been applied, and perhaps even opine with respect to how he believes, based on his experience, they should be applied. But I think the objection is well taken that his qualifications do not extend into the realm of economic impact of those policies."(Judge Walker, MHC v. City of San Rafael, transcript, 4/30/07, p. 189-208).*

[11] In his 2000 Castle MHP report for the City of Capitola, Baar conceded that rents have kept up with inflation since 1980, but repeated his claim that "… from 1913 to 1980 rents increased at about two thirds the rate of increase of the CPI …" ("Analysis of Castle Mobilehome Park Rent Increase Application", September 2000, p. 17).

> *"The leveraged nature of real estate investments may allow investors to obtain a reasonable return on their investments when rates of indexing are well below 100% of CPI. As a result of the leveraging factor, the return on investment may be a multiple of the rate of increase in the net operating income and value of the property."*[12]

What Baar means by "the leveraging factor" is that i) real property is commonly purchased with a mortgage, and ii) in the short run, mortgage debt is fixed in the sense that mortgages don't increase when rents, net income, and property values increase. Therefore if rents increase by something less than inflation but by enough to cover expense increases, the value of the property will rise, increasing the owner's equity.

Baar seems dazzled by the fact that inflation causes equity increases over the course of real estate investments. He portrays a typical mobilehome park investment "hypothetical" that shows the park owner's equity increasing, even with less than inflation rent increases, by 43% during a time period when prices increased by 50%.[13] But Baar doesn't mention the time period implied by his hypothetical. It took fourteen years, from 1994 to 2008, for the CPI to increase by 50%.[14] Dividing 43% by 14 results in an average annual return of 3.1%, which puts Baar's hypothetical in realistic perspective and undermines his belief that such an increase guarantees a fair return or that investments in real estate, because of inflation, leveraging, or for any other reason, make above normal returns. Considering inflation, the 43% increase in equity represents a loss, not a gain.

A more fundamental fallacy underlies the entire hypothetical. For Baar's scheme to work, someone has to be prepared to buy the property at the end of the holding period at the same cap rate that applied at the beginning. But the buyer will either have to put up the extra cash or suffer reduced cash flow because of a larger mortgage. Whereas the original investor in Baar's hypothetical purchased the property at a cap rate of .09 for 30% down, the buyer hoping for similar cash flow will have to purchase the property at the same cap rate for 42% down. After another period, for this plan to work, a subsequent buyer would have to put up 50% down, and so forth through successive ownerships, with the down payment ratio rising with each sale. If we assume that the buyers do get 70% financing, just as the original owner did, increased debt service costs will cause subsequent investors to receive progressively lower net returns. In addition, it is demonstrable that expense ratios (the ratio between operating expenses and rental income) will increase over time.

[12] Baar, K., "Analysis of Wishing Well MHP Rent Increase Application", October 2004, p. 22.

[13] Baar's leveraging hypothetical appears, with slight variations, in many Baar reports on rent increase applications. It appears on page 22 in the Wishing Well report, but note that Baar's chart mistakenly says 40% not 43%.

[14] The San Francisco Bay Area CPI was 148.7 in 1994. In 2008, at 222.8, it was 49.8% higher.

This is not market-realistic. The real estate market doesn’t work in the way Baar suggests. Banks won't grant ever larger mortgages when expense ratios are increasing. Investors won't be willing to invest higher and higher percentage down payments. The park owner will therefore have to offer the property at a lower price (higher cap rate) to induce a buyer to take the property over. A lower price means less return to the seller. So the increase in equity that Baar posits won’t materialize. Instead, there will be more moderate returns, possibly losses. Partial indexing is incompatible with the fair return principle.

Baar’s hypothetical is analogous to a Ponzi scheme, no more realistic than Bernie Madoff’s promise of extraordinary, risk-free returns to his gullible, wealthy investors. Baar’s model doesn’t cover long run outcomes and isn’t market-realistic. His “hypothetical” is an attempt to prove the unprovable: that partial inflation adjustments – also known as “partial indexing” - can provide a fair return on investment and that rent control with partial indexing can comprise a steady state solution. It can't happen. Full inflation adjustments (100% indexing) can lead to a steady state and a fair return, but incomplete CPI adjustments (partial indexing) never will.

FAIR RETURN STANDARDS

Rent control programs need a fair return standard in order to ensure that the fair return principle is satisfied. There are two fair return standards that have been found to be workable in the mobilehome rent control context. One can be called “Fair Return on Investment”. The other is usually called “Maintenance of Net Operating Income”.

The Fair Return on Investment formula says to take the original investment in the park (the entire purchase price if it was purchased as a park or the land purchase plus construction cost if it was built by the current owner), index that to account for inflation, and then apply the capitalization rate implied by recent sales of mobilehome parks as a rate of return. Here's an example:

1.	Original Cost = Investment:		$5,000,000
2.	CPI increase from date of purchase to today:	20%	
3.	Investment in today's dollars [#1 x (1+#2)]:		$6,000,000
4.	Capitalization Rate for Comparable Parks:	.068	
5.	Fair Net Operating Income [#3 x #4]:		$408,000
6.	Operating Expenses:		$157,000
7.	Fair Rental Income [#5 + #6]:		$565,000
8.	Number of spaces:	125	

9.	Fair Rent per space per month [#7 / 12 / #8]:	$377
10.	Actual current average rent:	$335
11.	Justified average space rent increase [#9 - #10]:	$42

Quoting the 1997 decision in the case known as Kavenau v. Santa Monica Rent Control Board (which itself was quoting a long-standing principle of law), Kenneth Baar says that "Of all possible standards, [this standard] comes closest to meeting the oft-repeated judicial guideline of providing a return that is 'commensurate with returns on investments in other enterprises having comparable risks'."[15]

The Maintenance of Net Operating Income (MNOI) formula, although not a fair return on investment formula (because it doesn't use investment at all), is the formula most often used in California rent control contexts. The MNOI formula says that park owners have the right to maintain the inflation-adjusted value of the net operating income achieved in the year prior to the imposition of rent control. The assumption is that rents at that time, set under free market conditions, were at market.

Here's an example of a typical MNOI calculation:

1. Base year income:		$465,833
2. Base year operating expenses:		$130,833
3. Base year net operating income [#1 - #2]:		$335,000
4. Inflation since base year:	20%	
5. Inflation-adjusted base year NOI [#3 x (1+#4)]:		$402,000
6. Current year expenses:		$157,000
7. Justified current year income [#5 + #6]:		$559,000
8. Actual current year income:		$502,500
9. Justified rent increase [#7 - #8]:		$56,500
10. Number of spaces:	125	
11. Justified rent increase per space per month [#9 / 12 / #10]:		$37.67

There are fine points about the application of each of these formulas. But if these formulas are applied honestly to actual parks, and if appropriate adjustments are made in recognition of

[15] Baar, "Fair Return Standards …", Real Property Reporter, Vol. 29, No. 5 (September 2006), p. 339.

unusual circumstances, the two will be mutually reinforcing in the sense that they will lead to similar rent increases, as they do in these examples. The fair return principle will be upheld by either formula.[16]

In rent control advocate Baar's hands, however, the MNOI formula will never provide a fair return because Baar, following his misunderstanding about real estate investments, advocates for "partial indexing". Instead of adjusting the base year net operating income for inflation in the obvious way (step 5 above), Baar advocates for adjustment by 40% to 75% of inflation, failing to understand or acknowledge that "less than inflation" is "less than a fair return".

VACANCY CONTROL / DECONTROL

The California legislature allows jurisdictions to enact rent stabilization programs, but the legislature has determined that apartment rents should be allowed to go to market on turnover.[17] This is a very significant condition. Jurisdictions like Berkeley and Santa Monica can restrict apartment rent increases during each tenancy, just as property tax increases are restricted during each property ownership under Proposition 13, but on turnover, rents go back to market.

The return to market rent is important. It means that the gap between controlled rents and market rents doesn't get too large. In the mobilehome context, it would mean that mobilehome and park values wouldn't get distorted too far from their natural values. Property owners would have the funds with which to properly maintain their property. Tenants would be assisted by relative stability in rent payments during their tenancy, but rents would go to market on vacancy, just as property taxes are re-set under Proposition 13 when property is sold. Vacancy decontrol restores balance. If property taxes didn't adjust to market on sale, the California budget crisis would be far worse than it is today. If apartment rents didn't adjust to market on turnover, there would be a continuing crisis in the apartment rental market in California, just as there has been under a vacancy control type of rent control in New York City for more than half a century.

Unfortunately, mobilehome park rent control was left out of California's statewide decontrol law. Mobilehomes were seen as significantly different from apartments. Jurisdictions are therefore still free in the case of mobilehomes to enact rent control with vacancy controls.[18] The

[16] It is noteworthy that the MNOI formula follows guidelines 1, 2, and 3.

[17] The state law is known as "The Rental Housing Act of 1995" or colloquially as "Costa-Hawkins" after the legislators who introduced it.

[18] Jurisdictions are on notice, however, by the outcomes of recent lawsuits in San Rafael and Goleta, that the courts may hold cities accountable for the economic damage that rent control with vacancy control can do to mobilehome parks. The City of

impact of space rent control on mobilehome parks and mobilehome residents is large, and tends to grow larger over time. Mobilehomes gain market value far in excess of their intrinsic value because buyers are not just buying a home - they are also buying the right to rent controlled rents.

The downside of this situation (other than its intrinsic unfairness to park owners) is that the enhanced affordability created by rent control is lost after one generation. The first homeowner, having benefitted from rent discounts during his stay, then sells his mobilehome at a price increased by the promise of future rent discounts, a windfall gain he hasn't earned and to which he has no right. The second generation homeowner, if he wants to live there, has to pay the present value of the future rent discount embedded in the increased purchase price of the home. The rent discount is offset by the additional cost of the home. The second generation homeowner pays less in rent, but more for the home, and is therefore no better off than he would be with no rent control at all. Rent control, under such a scheme, transfers wealth from park owners to current residents, but contrary to its advertised virtues, makes no effective impact on the long term affordability of mobilehome housing. Rent control with vacancy control is a scheme that benefits current mobilehome residents, no one else.

Perceptions on this topic, like the perceptions about fair return and indexing, have been much influenced by rent control advocate Kenneth Baar. Writing in 1992, characterizing the mobilehome park arrangement inaccurately as "monopolistic", Baar said that controlled rents should remain in place when mobilehomes are sold.[19] Otherwise, Baar said, excessive rent increases on vacancy could lower the value of mobilehomes. It is even possible, Baar often warns, for rent increases to make mobilehomes unsalable, forcing mobilehome owners to abandon them or sell them to a dealer or to the park owner at fire sale prices.

These warnings are not entirely without reason. There are cases where large space rent increases have reduced the values of mobilehomes. But those cases are the exceptions that prove the rule. Aside from a handful of special cases, the market works smoothly.[20] In jurisdictions with vacancy decontrol and jurisdictions that have no rent control, sales of mobilehomes proceed

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Goleta is now faced with the possibility that the City will have to pay the park owner back for the economic losses its rent control program has caused.

[19] Baar, Kenneth K., "The Right to Sell the "Im"mobile Manufactured Home in its Rent Controlled Space in the "Im"mobile Home Park: Valid Regulation or Unconstitutional Taking?", Urban Lawyer, Vol. 24 (Winter 1992), p. 110.

[20] There have been a few notorious cases like De Anza in Santa Cruz and Monte del Lago in Castroville where rents for mobilehome spaces in spectacular, oceanside locations have been greatly increased by new park owners as part of a transition of the park to an exclusive community for wealthy retirees. There is no way that this will happen at most mobilehome parks because most parks don't have the potential to be developed in this way.

without impediment. The market is balanced. Mobilehomes are bought and sold at reasonable prices. Market rents prevail on turnover. There is no exploitation.

When there is rent control with vacancy control, on the other hand, the market doesn't work properly. Rent control with vacancy control tends to cause the values of mobilehomes to increase far more than the housing market would allow. Older mobilehomes that have intrinsic value of, say, $15,000 to 25,000 sell in rent controlled communities for $50,000 to $100,000 or more. Newer mobilehomes that have intrinsic value of, say, $75,000 to $100,000 sell in rent controlled communities for $150,000 to $200,000 or more. Rent control with vacancy control tends to force the market out of balance.

Meanwhile, with rents increasing at less than the inflation rate and with no safety valve on turnover, mobilehome park values tend to stagnate or decline. Parks then don't have the funds that allow proper maintenance. Improvements (streets, lighting, clubhouse repairs, and the like) are delayed or not made at all. Parks begin to look run down. Eventually, there can be neighborhood decline and urban decay.

Several economists have examined the relationship between space rents and mobilehome values.[21] The universal conclusion, published by these economists in peer-reviewed journals, is that rent control with vacancy control causes the values of mobilehomes to rise. Nowhere in the literature of economics or housing policy are these findings meaningfully questioned. Yet Baar continues to question that rent control with vacancy control causes mobilehome values to rise and continues to argue that vacancy controls should be imposed universally.

AGEING RENT CONTROL

The vacancy control issue merges with what is becoming known as the "ageing rent control" issue. Many of California's mobilehome rent control ordinances were passed in the late 1970s or early 1980s. Some are now almost 30 years old. For those with vacancy control and partial indexing – the deadly combination – the effects are extreme, pernicious, and growing. Partial indexing doesn't do much damage over a year or two, but over one or more decades, the damage can be severe. In places such as Santa Cruz County and Carson City,

[21] Hirsch, Werner Z. and Joel G., 1988, "Legal-Economic Analysis of Rent Control in a Mobilehome Context: Placement Values and Vacancy Decontrol", UCLA Law Review, 35. Zheng, D., Dale-Jorgenson, D., et al, "An Examination of the Impact of Rent Control on Mobile Home Prices in California", Journal of Housing Economics, 16 (2007), 209-242. Mason, Carl and Quigley, John M., "The Curious Institution of Mobile Home Rent Control", Journal of Housing Economics, 16 (2007), 189-208. Quigley, John, "The Economics of Mobile Home Rent Control: A Case Study of Goleta, California" (August 11, 2004).

long term rent control with ineffective or unfair space rent increase mechanisms is threatening the viability of the entire mobilehome park arrangement.

It is possible that cities and counties may in this way kill the arrangement that provides affordable housing to thousands of low and moderate income households. In Santa Cruz County, the County is buying parks and selling them to the residents, but that solution will not work for most cities. In some locations park owners are simply buying mobilehomes one by one as they become available and renting them out because there is no rent control on mobilehome rentals. In other locations, parks are deteriorating. In some areas much affected by long term rent control, entire neighborhoods are deteriorating.

In New York City an ageing rent control program is credited with the loss of hundreds of thousands of rental units in buildings eventually abandoned by their owners. Rent control contributed maliciously to the urban blight that engulfed Miami Beach in the 1970s. Ageing rent control contributed likewise to the neighborhood deterioration that made East Palo Alto for several years the “murder capital of the West”. These outcomes are likewise possible in California cities and counties supporting restrictive mobilehome rent control. These outcomes can be prevented, however, if jurisdictions follow the guidelines in this report.

THE RENT CONTROL SOLUTION

Rent control, in most locations, is neither necessary nor advisable. Mobilehome park residency works perfectly well in the hundreds of jurisdictions, thousands of parks, and tens of thousands of California mobilehome spaces that have no rent control.[22] There was a rush to institute rent control programs in the late 1970s through the early 1990s. Rent control – a program that promised something for nothing - was popular at that time. Thereafter, there have been a few jurisdictions that have enacted rent control and several that have abandoned it.[23] It is now better understood that rent control, because it addresses the concerns of residents without addressing the concerns of park owners, is not a balanced solution. More and more frequently, cities and counties that consider these questions are looking for solutions that meet the needs of all stakeholders. More and more often, rent control is understood to be a heavy-handed, one-sided, divisive approach that causes civic conflict, is expensive, and doesn't always keep space rents down. The space rents in the rent-controlled city of Salinas in Monterey County, for example, are higher than most free market space rents in nearby Marina on the coast.

[22] It is noteworthy that other states such as Nevada, Arizona, New Mexico, Florida, and Texas, have mobilehome parks but no rent control. The market appears to work smoothly in those locations.

[23] The total number of mobilehome rent control ordinances in California has hovered around 105 for two decades.

A key problem with rent control is that it is subject to political pressure. In theory, it would be possible to structure rent control programs that would meet the needs of park owners and mobilehome owners simultaneously, but with remarkable consistency, rent control programs "go too far" in their effort to protect tenants from rent increases. Most rent control ordinances are written from a pro-tenant viewpoint. Programs that are balanced on inception tend to be revised over time in an unbalanced direction. When economic rights become a political matter, it is just too easy for things to slip out of balance. There are, after all, many more mobilehome owners than there are park owners. So local political pressure tends to lean toward residents. Park owners are few in number, sometimes don't live in the same community as their park, and therefore often have no effective voice. It is not surprising that rent control programs too often address the needs of mobilehome owners but neglect the needs of park owners, and thus, in the end, imbalance the market.

An example of the pro-tenant drift of rent control is the Santa Cruz County rent control ordinance. Passed in 1982, the ordinance was moderate, providing for 100% CPI adjustments and allowing reasonable increases to cover unusual cost increases. The ordinance was amended 19 times over the next quarter century – almost always to make it more restrictive. The ordinance now allows space rent increases covering only 50% of CPI, allows almost no pass-through increases to cover unusual cost increases, and controls rents strictly on vacancy. As a result, space rents in Santa Cruz County are in the $200-$300 range, far below market rents for Northern California.

Another problem with mobilehome rent control that will eventually become critical is that mobilehome park infrastructure deteriorates over time. Park owners are required to maintain services, but park owners under rent control don't have the ability or incentive to replace ageing infrastructure. Septic systems, roads, and utilities get old, deteriorate, and are subject to failure. Park residents typically argue against the pass-through of the costs of capital improvements. Park owners therefore patch and repair instead of replacing or upgrading. Many parks, for example, were built with 30-amp electrical systems. We all use far more energy than that today. But park owners under rent control can't afford to upgrade to 100 amp service. Similarly, many parks are served by failing septic systems, but park owners can't afford to upgrade or to connect to public sewer systems.

Indian Springs Mobilehome Park in Desert Springs was required by the water district to abandon its septic system and connect to the county sewer. But the rent review board denied the park owner's application for a pass-through of the costs of sewer construction. The park owner would surely have sued. To avoid litigation, the county ended up paying for this improvement.

Santa Cruz County bumped into the infrastructure problem recently. Having acquired Pleasant Acres Mobilehome Park for $7 million in 2003, the county then found that it cost an additional

$4 million to make needed infrastructure repairs. What seemed like a good opportunity to secure 65 units of affordable housing at a reasonable price turned out to cost far more than the County anticipated: $108,000 per space initially and then $62,000 per space in infrastructure upgrades, bringing the cost of each space to $175,000. If this were to be realistically covered by space rent, the rent would have to be something like $1,500 per month – completely incompatible with the affordability goal. It is clear that Santa Cruz County taxpayers will be subsidizing the rents of Pleasant Acres residents for a long, long time, and that the city or county purchase model won't work in most locations.

Another problem with rent control is that the rent control subsidy is not targeted. There is no "means testing" under rent control. Rent control benefits all residents, whether or not they need assistance. It usually benefits even those mobilehome owners who live elsewhere and rent their mobilehome or use it as a vacation home. Many residents can well afford market rents while other residents have limited incomes. Rent control, a blunt instrument, doesn't distinguish between these groups or target assistance to those who need it. Other assistance programs, like the Federal rent subsidy program known as Section 8, the food stamp program, and Medicaid, are much better at targeting assistance to those in need.

Rent control programs tend to dominate local politics. Cities with rent control often become polarized into divided camps. This is particularly true in cities with apartment rent control, like San Francisco, Santa Monica, West Hollywood, and Berkeley, but it is also true in some mobilehome rent control communities, like Escondido and Carson. Rent control is a pocketbook issue that arouses passionate advocacy. Many communities prefer to steer clear of rent control in order to avoid these kinds of partisan battles.

Rent control programs are also expensive. Leaving aside the costs of litigation, rent control programs are costly to administer, burdening municipal budgets. The administrative costs might be charged to park owners through registration and petition fees, but it would be normal to allow the fee or a part of the fee to be passed through to residents in the form of rent increases or a rent surcharge. Fair return principles command that government fees are costs that deserve compensation. One way or another, residents are likely to end up paying at least part of these fees. This would add to the cost of mobilehome residency, undermining the affordability goal.

And then there are the costs of litigation. Rent control has caused an enormous amount of litigation in the past three decades. The legal principles underlying rent control are complex and unsettled, so the same issues are litigated again and again in different forums. The cost of litigation has caused several cities to give up on rent control altogether. A recent example of this is the City of Santa Cruz, which abandoned its rent control program in 2003 because the costs of litigation became unsupportable. Another example is Hollister, where protracted litigation caused the City, its residents, and the park owners to agree on a model lease program that replaced rent control in 1994. The recent decision in Guggenheim v. Goleta serves to warn municipalities that enacting rent control may be costly; the judge found that rent control was a taking of property, and ordered that just compensation be paid by the city to the park owner.

As the court in Goleta said, the most basic issue with rent control is that by regulating rents too strictly it "goes too far", burdening a few individuals (park owners) with tenant subsidies that should be paid for by the entire community. Other housing assistance programs, like Section 8, Shelter Plus Care, and first time homeowner programs, are paid for by the taxpayers. The burden is widely spread and shared by all, as public burdens should be. With rent control, the financial burden of public assistance is shifted to park owners alone. Rent control programs are therefore on weak ethical grounds. Forcing park owners to underwrite rent subsidies so that the community can address a perceived problem with affordability is fundamentally unfair and therefore inherently unstable.

For both political and practical reasons, however, abandoning rent control, once it is initiated, is extremely difficult. Year by year, as space rents are constrained below market by rent control, the values of mobilehomes in the park increase. Over time, residents become used to this and consider the value to be theirs by right. New residents, relying on rent control to keep rents low, buy older homes at prices far above their intrinsic value. Those mobilehome owners have invested hard cash in reliance on rent control. If rent control were to be abandoned, they would lose their investments because the value of their homes would fall as the "premium" was returned to the park owner. No wonder mobilehome owners resist the abandonment of rent control. No wonder rent control becomes a part of the political culture in jurisdictions that adopt it.

Nevertheless, pressures rise, and there are communities that have found a way to abandon rent control. Most often, abandonment is gradual, allowing space rents to go to market upon turnover, but allowing current residents to remain in their homes paying controlled space rents for their lifetime. This is what happened in Santa Cruz when the costs of litigation became too much for the City. A deal was struck with the owner of De Anza Mobilehome Park whereby rent control was phased out. Current residents could stay for up to 34 years with controlled rents. But upon their departure, the rents could go to market.[24]

Alternatively, communities sometimes replace rent control with a model lease backed by a memorandum of understanding. Such arrangements ensure that rents won’t increase dramatically, but that park owners will be able to increase rents to cover cost increases over time. This was the negotiated solution in Hollister and Ontario, for example.

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[24] This was also the court-imposed solution in San Rafael. The outcome of the MHC case was that residents could keep rent protections for the duration of their tenancies up to 30 years, but that upon their departure or the sale of the mobilehome, rents could go to market.

California communities that have repealed rent control include the following:

- Napa (1985)
- Westminster (1985)
- Los Angeles County (1994)
- Delano (1994)
- Cotati (as to apartments, 1996)
- Hayward (as to apartments, 1990)
- Hollister (1994)
- Arroyo Grande (1998)
- Ontario (1999)
- Santa Cruz City (2003)

It is likely that the list will grow as communities come to understand that rent control is an inherently unbalanced arrangement and that it causes problems that grow over time, threatening the stability of the mobilehome / mobilehome park arrangement.

This is not to say, however, that communities should not address the economic insecurity that attends mobilehome residency. It is understandable that residents would request rent control when they feel threatened by actual or potential rent increases. There is inherent tension between park owners' ability to increase rents and residents' investments in their homes. Any of us would prefer economic security to economic insecurity, especially at a time when the economy is unusually unsettled. But rent control is neither the only nor the best solution to the insecurity that accompanies the mobilehome arrangement. It is appropriate for cities to listen carefully to residents' and park owners' concerns and to explore ways to bring balance to the marketplace.

ALTERNATIVE SOLUTIONS

More and more communities are looking into a cooperative alternative – model leases negotiated among residents, park owners, and local government. These leases provide protections similar to protections provided by rent control without succumbing to rent control's tendency to be one-sided, to "go too far", or to become gradually more restrictive. Model leases, unlike rent control, are not subject to political influence. Model leases have all the stakeholders at the table when the key decisions are made and therefore have the potential to be fair, stable, and long lasting.

An example of a model lease program is the "Memorandum of Understanding" (MOU) that was the outcome of a task force effort in Marina, California in 2003. Concern at that time about rent increases in one of the parks led to calls for rent control. A task force composed of residents, park owners, and City officials was convened. It was agreed at that time that rent control could be avoided if owners and residents could agree to moderate limits on rent increases. Agreement was reached. MOUs were established. The MOUs provided for CPI increases, pass-through of tax increases, utilities, and capital improvements, and increases to the County median rent on turnover. A mediation process was set up to handle disputes.

Things went well for several years, but in 2007, a new park owner who had not signed the MOU raised space rents significantly. Residents were fearful that the MOUs would fall apart and that rents would be increased in other parks. The City Council became interested. Attorney Kenneth Baar and economist Michael St. John were hired separately to study the Marina mobilehome market and to make recommendations. Baar recommended rent control. St. John recommended a MOU. A new task force has been convened in Marina to work on a new MOU and model lease, but residents are still asking the City Council for binding rent control. The outcome is at this time uncertain.

The City of Ontario enacted rent control in 1990. In 1999, stakeholders negotiated an Accord that seemed fair to park owners and residents alike. Rent control was repealed. In 2003, when the initial Accord would have expired, the Accord was extended for another four years without modification. In 2007 the Accord was amended and extended yet again. The amendments included the recognition that 100% CPI rent increases were in some cases not adequate to cover cost increases faced by park owners. The new standard is 120% of CPI with a cap of 10% and a floor of 4%. Property tax, utility, and capital improvements costs can be passed through to residents, but are subject to review by the City.

Modesto has recently decided on a comprehensive approach to space rent issues. One park in Modesto was raising rents significantly. There were calls for rent control. The city council, city staff, park owners, and residents considered the options. In the end, after a year of study and discussion, it was decided that a rent control ordinance would be enacted but that any park abiding by a city-negotiated MOU would be exempt from the ordinance. Cooperating parks would use a model lease worked out in negotiations among residents, park owners, and the city. Park owners would contribute to a fund to be used to for rent subsidies for low income residents. The City agreed to match park owner contributions. Lease terms include: 100% CPI with a cap of 7% and floor of 3%, pass-through of property taxes, capital improvements, and insurance, and 15% rent increase on vacancy. Eight out of nine parks in Modesto have signed the MOU. The remaining park is subject to the rent control ordinance.

An alternative that directly addresses the difficulty some residents have in paying space rents is a subsidy program. Some jurisdictions, believing that low incomes, not high rents, are the problem, have instituted programs similar to the Section 8 program to assist low income residents with their space rent. A significant advantage to subsidy programs is that assistance is targeted to those who need assistance. Under rent control, in contrast, there is no targeting, so that much of the rent control subsidy is wasted on people who don't need it.

Section 8 funds, in theory, are available to supplement space rent for low-income residents, but in practice Section 8 is not a reliable source for mobilehome owners because HUD funding has been significantly reduced in recent years and because some administering agencies won't use Section 8 funds for space rents. The Section 8 program is therefore not able to assist all mobilehome residents whose space rent is unaffordable.

The City of Turlock in 2007, acknowledging that income, not rent, was the problem for low income mobilehome residents in Turlock and that Section 8 couldn't be relied on at this time, rejected rent control in favor of a City-funded subsidy program. The program involved an agreement by participating park owners to accept as space rent for any qualifying resident an amount equal to the median space rent in Turlock. The City would then fund the difference between the median rent and the rent the resident could afford (30% of verified income). In Turlock it turned out that this program cost roughly $20,000 per year.

Many park owners fund subsidy programs on their own. There are park owners who have made an explicit commitment to reserve a percentage of space rent income for assistance to low income residents. Another model is a subsidy program jointly funded by the park owner and the city. Such a program might be administered by the city in question. The advantage of a jointly funded program is that it would require wider participation by citizens and stakeholders to address a community problem cooperatively.

Taking Marina, California as an example, if the park owners there agreed to donate 3% of gross rents to a subsidy fund, and if the City agreed to match these contributions, there would be a fund of roughly $12,000 per month that could provide rent subsidies averaging $120 per month for 100 households, roughly a quarter of all mobilehome households in Marina. Such a program would alleviate the affordability problems of the lowest income households in Marina's mobilehome parks without disrupting the market by the imposition of rent control.

A program of this kind is part of the Modesto solution mentioned above. Park owners have agreed to match City of Modesto contributions to $20 per homesite per year. If fully funded with matching funds, this program will generate a rent subsidy fund of close to $50,000 per year, a sum that could provide meaningful assistance to many low income park residents.

SUMMARY AND CONCLUSIONS

The dual objectives of mobilehome space rent control ordinances – to prevent excessive space rent increases and to allow park owners a fair return on investment – can be achieved simultaneously, but only by following the guidelines spelled out above:

- Rents must increase at the inflation rate.
- The costs of major capital improvements must be passed through to residents.
- Property tax increases occurring on sale of the property must be passed through.
- There must be periodic adjustments to market.

Rent control advocate Kenneth Baar, who speaks and writes on these topics frequently, has muddled the record by repeatedly taking indefensible positions on key issues – on partial indexing, on the effects of space rent restrictions on mobilehome values, and on the meaning of fair return in the mobilehome park context.

The positions Baar and other rent control advocates take on mobilehome park rent control promote conflict, encourage litigation, and discourage communities from adopting balanced policies that would simultaneously prevent excessive space rent increases and provide park owners a fair return on investment.

There are two fair return formulas that, fairly applied in accordance with the above guidelines, would achieve these objectives: the Fair Return on Investment and Maintenance of Net Operating Income formulas. The practical outcome of the two formulas will be similar in most situations.

Adherence to these formulas and to the guidelines set out in this report will bring balance to rent control debates, will modify the extreme positions that rent control advocates like Baar often take, and will allow communities to attend, instead, to steps that will promote the health of the mobilehome market, civic harmony, and a better quality of life for park residents.

In most jurisdictions, there is no need for programs of any kind. The market works perfectly well in most communities. When there is a perceived need for rent stabilization measures, a model lease and memorandum of understanding works far better than rent control. Unlike rent control, a model lease / MOU program doesn't set up an expensive bureaucracy, encourage extensive litigation, or cause unrealistic and unsustainable inflation in the values of mobilehomes.

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