ECON 197 Essay 3

# Supply Over Restriction: Why Housing Policy Needs to Move Away from Rent Control

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ECON-197

May 26th, 2026

U.S. metropolitan areas are facing a severe housing crisis, and the discussion about addressing it is going in the opposite direction. Advocates in California and Oregon are now promoting rent control measures, while others are advocating for even more restrictive forms of control. The argument made by advocates appears reasonable and straightforward. Rents are at historically high levels; many renters can't afford to pay market-level rents. Limiting rent growth and rent caps help protect residents who need to stay in their rentals and/or find new rentals. While advocates' arguments appear to be based on reason, applying economic theory to this problem shows that rent controls do nothing to correct the issue; they merely treat one symptom while leaving the fundamental issues unaddressed.

This paper supports shifting the focus from rent controls to supply-side-oriented policy reform. The primary market failure in American housing markets today is not landlords charging above-competitive rents in otherwise competitive markets. Rather, it is primarily the result of a lack of available housing (a supply issue) resulting from overly restrictive zoning regulations, lengthy and costly permitting processes, time-consuming environmental reviews, and height limits imposed on developers. All of these factors have resulted in a significant reduction in new development; therefore, there is insufficient available housing to meet demand. In this situation, where the housing supply is inelastic, any increase in demand will result in higher rents rather than additional available housing units. Therefore, the primary issue is supply, not price.

When developing policies to "fix" problems in housing markets, it is essential to first identify what failed and then develop corrective policies that accurately address those failures. In cities such as San Francisco, Los Angeles, New York, and Seattle, the primary market failures have been local zoning ordinances/regulations, permitting processes, environmental review requirements, and building height restrictions. Each of these has contributed significantly to creating barriers to new development and thereby restricting the supply of new residential construction. As a result, the supply of residential housing has been unable to meet increasing demand.

The data shows this clearly. As shown in Figure 1, a February 2024 Federal Reserve Bank of St. Louis analysis of rent control trade-offs found that the national rental vacancy rate has fallen to near-historic lows, reaching 5.6 percent in 2021. When the vacancy rates fall to this low a level, landlords face almost no competitive pressure to hold rents down. Any unit listed will be filled immediately. This is the market structure that determines the rents tenants face, and it is a quantity, not a price, problem. In urban areas with fewer barriers to new construction and zoning, like Houston, rents have grown far more slowly despite rising demand. This example shows that supply restrictions lead to high rents, but greater supply flexibility reduces the shock. Rent control responds to this failure by capping prices at the existing supply level, while leaving the real cause of the restricted supply unaffected.

Even if rent control were a well-designed policy, the response it triggers makes the shortage far worse over time. Landlords who face below-market returns on rental properties have two different options. They can convert units to condominiums, which removes them from the rental supply, or, more often, reduce investment in units, resulting in a decline in quality without reducing rents. As shown in Figure 2, from Diamond, McQuade, and Qian's 2019 study, landlords subject to San Francisco's 1994 rent control expansion were 8 percentage points more likely to convert their buildings or redevelop them entirely than landlords in the control group. This same study also found a 15 percent reduction in the rental housing supply in these affected buildings and further found a 25 percent decline in the number of renters living in rent-controlled units compared to 1994 levels. Rent control protects current tenants while simultaneously reducing the overall housing supply. Rent control solved the affordability problem for existing tenants but gave landlords an incentive to exit the rental market. Tenants already in units are protected, but tenants looking to rent pay a much higher market price in a smaller, less competitive market than they would without rent control. The redistribution under this policy shifts housing from future residents to current residents, without creating new units.

A “Supply-Focused” reform would include: rezoning residential areas to increase density; expediting zoning approvals for building permits; streamlining the environmental review process to avoid delays; and allowing Accessory Dwelling Units (ADUs) to be built on a property without extensive permitting. All of these reforms will reduce the cost of creating additional housing supply. These reforms address supply constraints rather than simply regulating the price charged. Rent control, by contrast, limits a landlord's ability to maintain profitability and expand their existing rental supply.

St. Paul and Minneapolis provide one of the clearest natural experiments for testing whether capping rents reduces the supply of rental housing.

St. Paul and Minneapolis are two cities located within the same metropolitan area. They both face similar regional economic factors, and each discussed the possible implementation of rent control policies in 2021. However, St. Paul ultimately implemented a strict rent stabilization ordinance that limited rent increases to 3 percent per year. New buildings constructed after the ordinance was passed were not eligible for any type of exemption. Minneapolis, on the other hand, chose not to implement any form of rent control and instead pursued its long-term supply-focused goals under the 2040 plan. The difference in permit issuance is clear and illustrates the supply-side position.

Multifamily dwelling permits in St. Paul fell by over 80% in the first three months after St. Paul's rent control measure was approved in November 2021, compared with the same period the prior year, according to HUD data published in MinnPost. In contrast, Minneapolis' multifamily dwelling permits rose by about 60% over the same comparison period. According to St. Paul's Planning and Economic Development Director, 515 permits for housing were issued in St. Paul from January to July 2022. These numbers represent a 31% drop-off compared to the four-year average for these months. A representative of the Minnesota Multi-Housing Association stated that approximately 3,100 units planned for development in St. Paul were either canceled or put on hold following the approval of the rent control ordinance. After approving the initial ordinance, the City Council subsequently voted to amend it to provide a 20-year exemption for new construction. Essentially, the city acknowledged that its original plan to cap prices reduced the supply of rentals it was intended to support.

This example is almost perfect. It is the same metropolitan area, the same regional economic conditions, the same time frame, and a different policy. One city limited price growth. The other city built. The city that limited price growth experienced a collapse in construction activity, while the other experienced an expansion. This is exactly what economic theory predicted.

The biggest drawback to supporting the "supply side" is not that rent controls work well over time. Rather, it is that supply-side reforms, which include zoning changes, take so long and benefit their intended recipients in such an inequitable way that they provide little or no assistance to tenants whose rents are about to rise by 40% over the next six months. Families will have to wait three to seven years from the date of approval for a newly zoned project before they can occupy an apartment in the building being developed. While rent control may be an imperfect solution, it at least immediately protects families who would otherwise be displaced by rent increases. Additionally, the distributive impacts of new construction in high-cost areas are often skewed towards luxury rentals. This occurs for two reasons. First, the costs in high-cost cities are very high. Second, while private developers develop a large amount of housing in cities like San Francisco and New York City, they do so primarily at higher-end rental prices. There is some truth to the idea that the new luxury units would eventually filter down into lower price ranges. However, it can take 15-20 years for new luxury units available for lease to filter down into lower-priced units. Thus, supply-side reform has significant distributional disadvantages over time compared to rent controls.

There is no question that rent control has a valid short-run justification, but this will never outweigh its long-run objections. If rent control could be implemented as a temporary bridging policy, it would be phased out once new supply comes to market. It would be a justifiable policy to provide immediate relief until the supply adjusts and catches up. However, this is not how rent control is implemented, nor how it works politically. Once passed, rent control is virtually impossible to repeal. Tenants who currently occupy apartments under rent control have a strong incentive to protect their artificially low rents. Conversely, most of the population lacks an equal or comparable organization to promote their interests. The St. Paul data presents an even clearer picture than does any theoretical framework regarding the timing of filtering. In St. Paul, developers did not need to wait months to discover how well the rent control ordinance worked before changing their pricing calculus; instead, they changed it almost immediately upon learning that the ordinance had passed. The roughly 3,100 canceled or delayed units in St. Paul were not a function of a long-term issue. Instead, they represented a short-term supply-destruction issue caused directly by rent control. The true policy failure in most American cities is not that the wrong kind of housing was built. Rather, it is that too little housing was built at all, because policies have made it economically unviable.

Finally, supply reform can be combined with targeted affordable housing strategies, including mandated inclusionary zoning requirements. This is not a perfect solution, as it could raise project costs enough to reduce the total number of units produced if the required percentage is set too high. Still, it represents a hybrid approach that offers near-term affordability assistance while increasing overall supply. Rent control without additional new supply produced a net benefit for current residents by providing near-term protection while creating long-term shortages that harm more residents. Thus, rent control without new supply is not an equitable solution. It is a distributive program in which the benefits accrue to one group of residents protected by current rent control laws, while the cost falls on potential future residents.

The issue of whether to have rent control has been argued to the end and has settled into two types of rhetorical failures. On one hand, proponents of rent control typically describe it as preventing landlords from arbitrarily increasing rents or protecting renters from greedy landlords. Both descriptions attribute high rents to the landlord's nature rather than recognizing that they are primarily a result of supply-and-demand dynamics in the housing market. The Santa Cruz rental market illustrates this. Rents are being charged at levels that allow renters to just barely afford them. In this way, the rents were used to capture all potential consumer surplus, not out of personal greed. Instead, in a supply-constrained market like the Santa Cruz rental market, there is an incentive structure present that rewards and encourages the behavior. This behavior by landlords can be defined as rent-seeking. Rent-seeking behavior involves extracting a greater share of existing resources without providing any additional value. Price controls (rent control), which reduce the maximum amount landlords can charge for their rentals, provide no additional value and only transfer the excess value created by limiting prices to currently renting tenants. At the same time, the overall number of available units continues to decrease. Advocates for land-use reform often suggest that removing most of our restrictive zoning laws would lead to the immediate development of large amounts of affordable housing for low-income families. This is also a misrepresentation of reality. Removing restrictions on zoning regulations allows developers to build more housing units. However, it does not allow developers to build cheaper units. There are still numerous other factors, including high construction costs, limited worker availability, and expensive financing, that affect how quickly new units are developed and at what price they are offered to consumers. True advocates for supply reforms should refrain from making exaggerated claims about how quickly new affordable units will become available. Both sides could improve the quality of the public debate regarding rent control and zoning regulations by acknowledging that both policies involve a trade-off. Specifically, rent control benefits those tenants currently living in restricted-rental areas and harms future generations of potential residents. Zoning reforms have no short-term impact on housing costs but create the long-term capacity for affordable housing options. The case study involving St. Paul illustrates the consequences of choosing price controls over supply reform. Roughly 3,100 planned units were canceled or delayed, and therefore did not provide homes for the individuals and/or families that needed them.

Rent-seeking refers to individuals seeking to maximize their returns based on the wealth they already possess rather than creating additional wealth. In other words, an individual seeking to raise their profits through means that do not add value to what they own. A classic illustration is a medieval landlord increasing rents as the tenant farmer's productivity increases, thereby allowing the landlord to capture some of that increased productivity without contributing anything to it. This is similar to how rental prices in the Santa Cruz housing market were set so high that tenants could barely afford them. Therefore, tenants had little ability to save enough to purchase homes, thereby eliminating potential demand for home purchases. The problem created by rent control is a direct reflection of this form of rent-seeking behavior. Controlled-unit tenants receive artificially low rental prices compared to what free markets would set. So, controlled-unit tenants become interested in defending their below-market rental rate through their political power and lobby against prospective tenants.  Both types of renters are essentially engaged in rent-seeking; neither contributes to the community's overall wealth or to the value of the housing inventory. The result is that the total number of houses available for sale decreases, and those most negatively affected are prospective renters, who have no opportunity to influence political decisions.

Corrective policies are most effective when they mirror the causal factor leading to the initial market failure. However, if they fail to account for this causal factor, new inefficiencies may be added to the original ones. The U.S. Superfund Program serves as a classic illustration of this principle. Prior to the expiration of the Superfund tax in 1995, polluters paid for cleanup activities resulting from pollution in a way that internalized the externality. Thus, when the tax expired, clean-up completion rates declined sharply because there was no longer an economically viable mechanism to correct this market failure. Rent control operates under the exact same structural constraints. The primary source of the market failure affecting American housing is insufficient housing supply due to overly restrictive regulations that limit construction. However, rent control does nothing to address the regulatory constraints that lead to an insufficient housing supply. Instead, rent control seeks to correct the price associated with insufficient housing availability, rather than addressing the constraints themselves. A corrective policy should mirror the original causes of the market failure. Supply-side reform represents a corrective measure that directly addresses the cause of the market failure. Applied consistently, this policy logic supports supply-side reform over price controls.

While public choice theory focuses primarily on how decisions are made within government, it also offers insight into why rent control persists despite empirical evidence that it fails. The logic of collective action suggests that policies that concentrate benefits among well-organized groups while spreading costs among less organized groups tend to be politically sustainable regardless of their economic viability. The housing market fails because of insufficient supply due to development restrictions. Rent control fails to correct this market failure because it identifies the wrong source of the failure. Additionally, rent control persists in our system because current renters are better able to organize politically, whereas future renters cannot.

Housing reform focused on supply is more economically justifiable than rent control because it targets the root cause of failure rather than merely one of its symptoms. The American housing crisis is a supply crisis. Cities have made it so expensive to build enough housing to meet demand that prices are rising directly as a result. Rent control responds by limiting the price of the existing supply of units, which is too small. Rent control helps some people who already have housing while hurting the larger group of people who need housing. All the evidence presented above shows historical tightness in rental markets, and the collapse in building permits in St. Paul after its 2021 rent control ordinance suggests the same. When supply is restricted and rents are capped, the total rental supply shrinks, and those who need the most available rentals cannot find them.

Rent control advocates most often make an equity argument against this position, but it also does not hold up under scrutiny. Rent control benefits households that have been in place the longest in desirable neighborhoods, not the economically vulnerable households. Those harmed the most by the shortage are the population who are unable to find rental units, and those priced out of the capped supply into an unregulated market with fewer options and higher prices. This is the population that this policy was designed to help. When a policy fails on efficiency grounds and fails to deliver the promised equity, there is no longer a case for it. Policy design that takes both types of failures seriously aims to reform supply. The opposing position on rent control as a housing policy is less economically defensible because it continues to misidentify the original cause of failure and guarantees that the policy's response will worsen over time.

**Figure 1: U.S. Rental Vacancy Rate, 1984–2023**

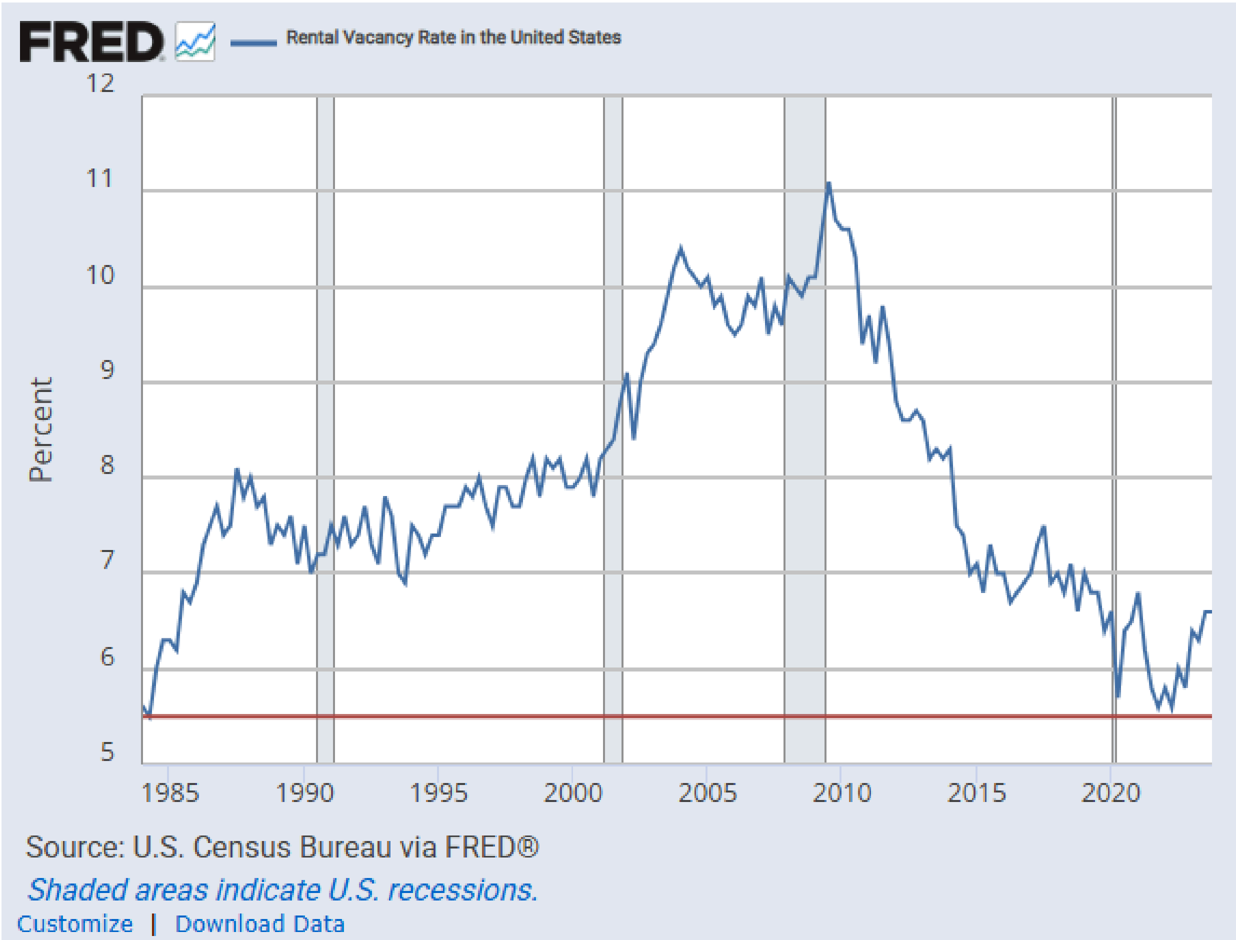



Figure 1 is from the Federal Reserve Bank of St. Louis's February 2024 analysis of rent control trade-offs, using U.S. Census Bureau vacancy data. It shows the national rental vacancy rate falling to 5.6 percent in 2021 and remaining well below the healthy range of 7 to 8 percent through 2023. When vacancy is this low, landlords face little competitive pressure to hold rents down, and prospective tenants have little leverage.

**Figure 2: Landlord Conversion Rates and Rental Supply Reduction Following San Francisco's 1994 Rent Control Expansion**

Figure 4: Treatment Effect for Tenants in Multi-Family Residence (2 – 4 Units)

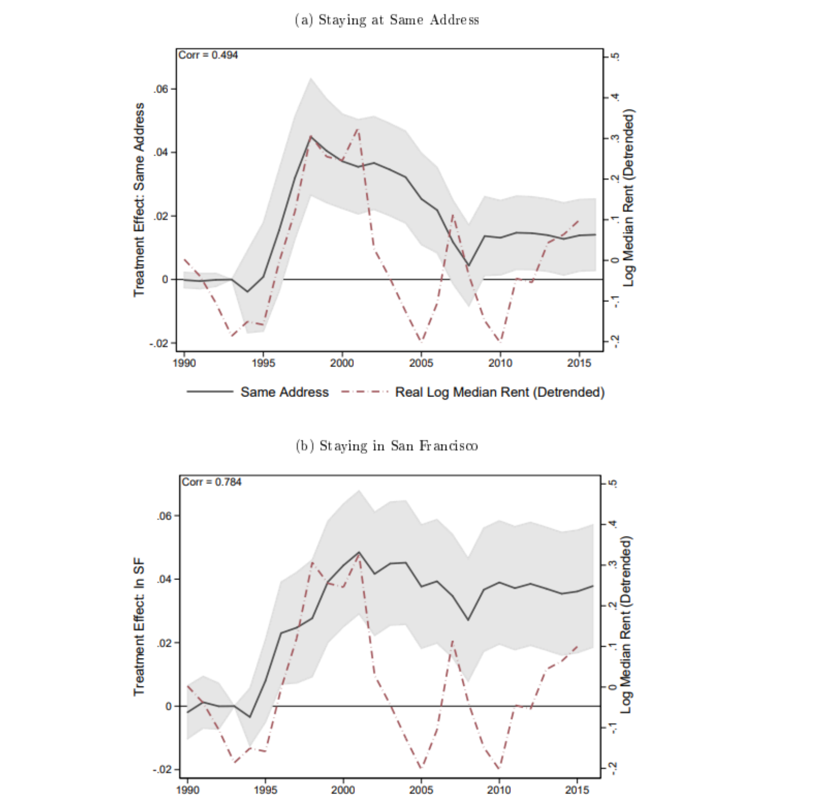
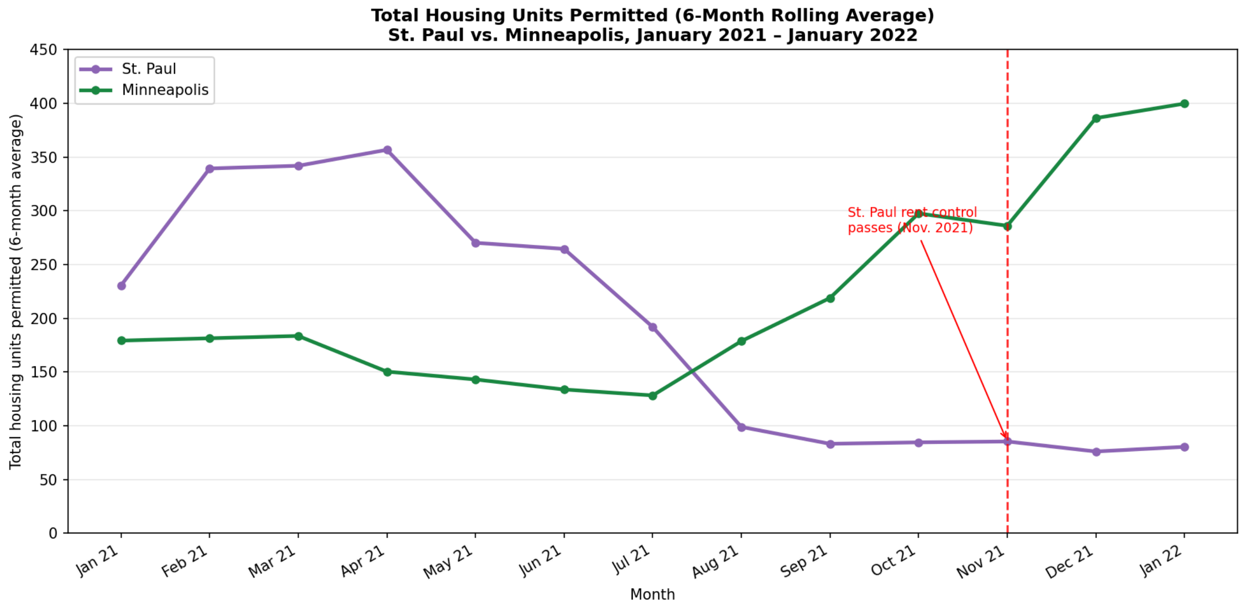



Figure 2 is from Diamond, McQuade, and Qian's 2019 study in the American Economic Review. The figure shows that landlords whose buildings were covered by rent control were 8 percentage points more likely to convert to condominiums or redevelop than the control group, resulting in a 15 percent long-run decline in rental units in treated buildings and a 25 percent decline in renters living in rent-controlled units.

**Figure 3: St. Paul vs. Minneapolis: Multifamily Permit Activity Before and After Rent Control, 2021–2022**




*Source: Lindeke, Bill. "In First Months Since Passage of St. Paul's Rent-Control Ordinance, Housing Construction Is Way Down." MinnPost, March 2022. Data from U.S. Department of Housing and Urban Development Building Permits Survey.*

Figure 3 presents multifamily housing permit data for St. Paul and Minneapolis before and after St. Paul's November 2021 rent stabilization ordinance. Minneapolis, which did not enact rent control and continued its 2040 Plan supply approach, increased multifamily permits by 60 percent over the same comparison period. St. Paul's own Planning and Economic Development director confirmed that January through July 2022 saw 515 permitted units, which is 31 percent below the four-year average for those months.

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