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Promoting Neighborhood Improvement while Protecting Low-Income Families

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Gentrification presents a quandary for government officials and urban planners concerned about the welfare of low-income families. Is there a sound policy or approach that would encourage development, but protect low-income residents? We suggest financial instruments to insure renters against price increases. Such a strategy can at the same time provide insurance to builders against short-term price reductions.

The comeback of sections of many inner cities is very good news. Progress against crime is allowing residents of poor neighborhoods to shop, play, and walk comfortably outside their homes for the first time in years. Efforts to clean up formerly dangerous and low-rent neighborhoods and enhance their safety are making them increasingly attractive to moderate-income individuals and families. With the inflow of new, higher-income families, neighborhoods with large numbers of poor people have begun to gentrify. Neighborhood gentrification can revitalize substandard housing and buildings; bring residents access to nearby grocery stores, banks, and other services; create additional job opportunities; and reduce crime.

But gentrification can also have negative side effects for low-income residents. As a neighborhood improves and attracts new residents and businesses, demand for property increases, causing rents and property values to rise. The high rents and increasing property prices bring benefits to homeowners and attract additional investors, but may also price low-income renters out of their own neighborhoods. Residents and their allies often protest against gentrification. As one neighborhood leader put it, "Gentrification is a nasty word. It really does knock out the people who have lived in an area for a long time."[1] Recent news articles report these dynamics playing out in Harlem, Bedford-Stuyvesant, and the East Village—formerly low-rent New York neighborhoods famous for their high crime rates, drug dealers, and abandoned housing.[2, 3]

Gentrification thus presents a quandary for government officials and urban planners concerned about the welfare of low-income families. Revitalization efforts could price low-income residents out of an area and force them to relocate, while fear of hurting low-income residents could prevent development and leave depressed neighborhoods to urban blight. Is there a sound policy or approach that would encourage development, but protect low-income residents and give them a **stake in improving their neighborhoods?** This brief proposes such an approach, one based on the purchase of options to rent in a given neighborhood at a given price for a specified number of years, or on the purchase of insurance against rent increases.

Existing Approaches

The existing strategies for dealing with the effects of gentrification on low-income renters include doing nothing, mandating rent control, subsidizing rental housing costs, decreasing barriers to building low-**cost units, and promoting homeownership** such that low-income households stand to benefit from increasing property values. All of these strategies are problematic.

Inaction reduces incentives for low-income renters to improve their neighborhoods, once the renters recognize that such improvements increase rental prices and could eventually price them out of the market. Rent controls stultify neighborhoods by reducing property owners' incentives to maintain property and to invest in added housing, inducing shortages and higher prices for uncontrolled units. Rent controls are neither efficient nor equitable (the transfers are neither equitably provided among the poor, nor are the costs fairly borne across the population).

Rent subsidies are not solving the problem either. Shielding low-income renters from the increased costs of gentrifying neighborhoods will be inequitable, since the government would be paying much more to some low-income renters than to others. Paying the same subsidy to all low-income renters will force those in rapidly gentrifying neighborhoods to move, because subsidies that are reasonable over all neighborhoods will be too small in high-priced areas.

Promoting homeownership makes sense in some contexts, but not all low-income families have the income base or experience to maintain their homes and to make regular mortgage payments. Given today's problems with rising foreclosures and high interest rates in the subprime mortgage market, it makes sense to consider additional mechanisms for low-income families to gain equity without facing excessive financial burdens.[4]

A New Concept

We suggest a new approach to renter protection—financial instruments to insure renters against price increases. Our concept builds on the work of Robert Shiller (1993), who investigated the development of markets related to price insurance for homeowners, to protect them from reductions in house prices. We extend Shiller's logic to the other side of the market—protecting renters against price increases. This protection might take two forms that have similar attributes: (1) tradable options on a rental- and neighborhood-specific price index, or (2) insurance against rent increases in a neighborhood. Although the two approaches could yield identical payoffs, they would vary in marketing approaches, types of transactions, ways of capitalizing expected rent increases, and availability to various market participants. In addition, the specific conditions of an options contract or an insurance policy could vary widely. Space permits us to address only some of these differences in describing our proposal.

The tradable option would be a financial asset linked to an index of area rents. Renters who obtain an option on this index would be shielded from rapid rent increases in their communities. If rents in the area rise, then the renter would see the value of his option increase; if rents decline or stay the same, the option would fall in value over time. When gentrification leads to sizable rent increases, renters would be able to use the increased value of their option to remain in their current units, using their option gains to offset rent increases; alternatively, they could move to another, low-rent location and apply the cash earned on their options to other expenses.

The options concept would require the development of an options market for neighborhood rent indices. A public-private partnership could create the contracts (specifying term lengths, strike prices, how owners could exercise their options, and the method of determining rent indices) and establish trading rules consistent with other exchanges. At that point, the partnership would attempt to turn over operations of the options market to an existing exchange. The exchange would handle options on rental indices in several areas throughout the country. Like other options markets, this one would be subject to oversight to deal with consumer protection issues.

Anyone, including renters and property owners, would be able to buy or sell an option. Speculators or investors would be welcome on both sides of the market, to increase liquidity and to reduce bid-ask spreads. For low-income renters, the purchase of an option might be subsidized. An alternative is for insurance companies to market policies that protect renters against future rent increases in much the same way that traditional insurance policies, such as homeowners' or renters' insurance, protect property owners. If rents in the area rise, then the renter would receive an insurance payment. An insurance scheme could also have a built-in cash-out option for renters who decide to move rather than continue to rent. If a renter purchases a plan guaranteeing ten years of insurance and the rent rises during year one, then the renter would be able to sell the plan to the insurance company for the expected future benefits that would accrue to the renter if the renter stayed in the present dwelling. Thus, under either options or insurance, the financial instruments would benefit renters who decide to move rather than continue to rent. This feature alone improves on rent control and some subsidy approaches by divorcing the compensation (for area rent increases) from the renter's subsequent choice of locations.

The benefit paid would not depend on the price of the renter's own unit, as this could create incentives for abuse by renters and landlords. Instead the benefit would be based on a measure of neighborhood or local rents, which cannot be manipulated by an individual landlord but which is highly correlated with price movements in rents of individual units. Shiller proposes several possible indices that could be used to measure area housing prices; similar indices could be constructed to measure neighborhood rental prices. In the case of insurance contracts, exclusions, caps, or deductibles may also need to be incorporated into the scheme to eliminate incentives for abuse.

What the costs would be for these options or insurance plans is unclear. One possibility is that the costs would be low because property owners want to hedge and are willing to buy insurance against reductions in neighborhood rents and property prices. In this case, insurance companies could serve mainly as an intermediary. Because insurers would be supplying services to both sides of the market, they would be protected against risk and could provide the service at relatively low prices. Alternatively, the options and insurance approaches could well operate in combination. The insurance companies could market products, but use the options market to limit their risks.

An advantage of either risk management strategy is that property owners and contractors would be able to hedge their risks of investing or remaining in low-income neighborhoods. This new opportunity would increase the incentive to build or to make improvements in existing dwellings. Rents might even fall in the long term, because the reduced risks would make banks and other financial intermediaries more willing to lend at low interest rates, lowering

a major cost of property owners. If few property owners hedge, insurance companies could take positions, diversifying their investments by selling policies in neighborhoods across the country and/or by buying real estate in linked markets.

Even if low-income renters were unable to purchase the options or insurance on their own, it might be worthwhile for municipalities to subsidize such purchases or to take the risk of selling the policies at a modest price themselves. In a sense, local governments would be hedging. If prices fell or remained constant, they would pay little or nothing. If prices rose, they would have to pay renters, but property values would have increased enough to yield the taxes to finance these payments.

Like any approach, this one is subject to limitations. One problem is that low-income renters might cash in their options or insurance policies at the wrong times. They might not recognize the value of holding these assets for the future or might feel forced to sell them before prices had reached their peak. Some limitations might be placed on those assets purchased with government subsidies (again, whether options or insurance). In any event, renters who chose to take advantage of gains too quickly would still have reaped some benefits from the increasing attractiveness of their neighborhoods. Developing an options market or a rental-rate insurance scheme to reduce risk for renters and property owners will not be simple. Reliable measures of neighborhood prices must be developed, a group of organizations must become market makers, and property owners and rental groups must show interest. Certainly, more research is appropriate at this point.

Some might ask, if such markets are profitable, why aren't they already operating? One answer is that as financial tools to manage risk become increasingly sophisticated, new markets continue to emerge. Already, the Chicago Mercantile Exchange has developed options and futures markets for trading future prices of residential real estate (based on an index of single family home prices) in ten U.S. cities (Chicago Mercantile Exchange 2007). Property derivatives, in which parties engage in "swaps" to trade the difference between the return on commercial property and some benchmark rate, have appeared in the United Kingdom.[5] Options are now also available on the German commercial property market.[6] Of course, extending these instruments to the U.S. rental market, by neighborhoods or other submetropolitan areas, is likely to prove more difficult and take additional time. However, the positive externalities generated by such a market may well justify some government support to speed its development.

In conclusion, we believe the concept has potential for protecting low-income renters without the stultifying aspects of rent control and other limitations on local development. These instruments would provide low-income renters with a financial stake in improving their neighborhoods, unlike today's situation in which low-income renters may be ambivalent. Moreover, the approach would provide a natural way of allowing low-income renters in gentrifying neighborhoods to choose whether to stay or to move. The increased values of their options or insurance payments could pay for the added costs of staying in the neighborhood, for a down payment for a house, or for general expenses after the family moves to an alternative low-rent neighborhood. Thus, in addition to protecting long-term renters in areas undergoing gentrification, such instruments could smooth the transition between renting and owning and help promote homeownership. For property owners, the availability of insurance against sharp reductions in rents would lower their risks and potentially increase their incentives to invest, as well as their ability to obtain low-cost financing. More importantly, these financial instruments would limit or even prevent the downsides of gentrification for low-income residents, help maintain diversity in neighborhoods, and thereby remove some of the opposition to development.

Notes

1. Jill Priluck, "Neighborhood Report: Bedford-Stuyvesant—Even in a Long-Troubled Section, Gentrification is on the Horizon," *New York Times,* December 10, 2000, sec. 14, p. 6.
2. Rachelle Garbarine, "Residential Real Estate in East Village, New Condo Project Sells Quickly," *New York Times*, November 17, 2000, p. B-9.
3. Alexandra Marks, "Churches Try to Preserve Harlem's Character," *Christian Science Monitor,* November 20, 2000, p. 2.
4. Gramlich (forthcoming) provides an excellent analysis of subprime lending and rising homeownership among low-income households.
5. The return to the investor in the property derivative is positive if the return on property (say, 5 percent) exceeds some benchmark rate (say, 2 percent) and is negative if the property return (say, 1 percent) is less than the benchmark rate.
6. Jim Pickard, "First Options on Property Mark a New Milestone," *Financial Times,* January 17, 2007, p. 23.

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Given the chance, many low-income families can acquire assets and become more financially secure. Conservatives and liberals increasingly agree that government's role in this transition requires going beyond traditional antipoverty programs to encourage savings, homeownership, private pensions, and microenterprise. The Urban Institute's *Opportunity and Ownership Project* policy brief series presents some of our findings, analyses, and recommendations. The authors are grateful to the Ford Foundation and the Annie E. Casey Foundation for funding the policy briefs.

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