

LEGAL ECONOMICS OF U.S. LOW INCOME HOUSING MARKETS IN LIGHT OF "INFORMALITY" ANALYSIS

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This essay proposes a general framework for understanding the phenomenon of neighborhood transitions in low income housing markets in large urban areas. It is an attempt to bring to bear on typical United Statesean phenomena the insights of a number of legal and non-legal disciplines and subdisciplines that have up to now had little to say to one another¹.

The type of phenomenon I will be discussing is well illustrated by a *New York Times* story from 1996 about the proliferation of illegally subdivided apartments in lower middle class residential neighborhoods in New York City.² The story emphasized fire hazards, the overcrowded and unsanitary conditions of the new units, and the external effects on neighborhood amenity. The author implied that the authorities were failing to enforce building and sanitary codes. Some days later, *The Times* carried an Op-Ed piece arguing that authorities should not enforce the building, health and safety regulations on these units because unregulated subdivision was good for new immigrant groups who would otherwise end up homeless or restricted to more expensive and less attractive units in the neighborhoods of their arrival in the City.³

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1. The first of these is the neighborhood dynamics approach in recent United Statesean planning literature. See Part I, *infra*. The second is the analysis of legal background rules characteristic of American critical legal studies. See Part III, *infra*. The third is the theory of "informality" in third world urban land markets. See Part IV, *infra*. A fourth is the emerging path dependence orientation in law and economics. See Parts II and V, *infra*.

2. Frank Bruni, *Behind a Suburban Façade in Queens: A Teaming, Angry Urban Arithmetic*, N.Y. TIMES, Oct. 8, 1996, at Metro Section.

3. Peter D. Salins, *How to Create a Real Housing Crisis*, N.Y. TIMES, Oct. 26, 1996, at op ed.

This paper tries to put this exchange and countless similar exchanges into the context of a general policy analysis of neighborhood change in low income housing markets characterized by significant "informality."

I. FOUR TYPES OF NEIGHBORHOOD CHANGE⁴

Consider four typical situations that sometimes exist in United States urban housing markets that are defined by neighborhoods.

I will call the first situation *upward filtering* or just *filtering*. In this situation, the neighborhood is "declining" because its population is shifting as low income people move into it, making it more heterogeneous, and some higher income people leave. Values are unstable. Density is increasing.

In the *downward tailspin* situation, the neighborhood is "declining" because many higher income people are leaving and the remaining population is rapidly becoming more homogeneously lower class. Values are declining. Density is decreasing.

In *upgrading in place*, the neighborhood is "improving," as a result of new investment by established low or lower middle income owners, without displacement of low income tenants, along with new construction for higher income in-movers. Heterogeneity is increasing. Values are increasing. Density is increasing.

4. The discussion of neighborhood change that follows is derived from the housing economics literature. The pieces that have influenced me the most are M. EDEL, *Filtering in a Private Housing Market*, in READINGS IN URBAN ECONOMICS (Edel & Rothenberg, eds., 1972); LITTLE, NOURSE AND READ, *Neighborhood Change, in LESSONS IN THE DYNAMICS OF URBAN DECAY* (Leven ed., 1976); ROLF GOETZE, UNDERSTANDING NEIGHBORHOOD CHANGE (1979), and Peter Marcuse, *Gentrification and Abandonment*, 28 J. URBAN AND CONTEMP. LAW 195 (1985) and *Neutralizing Homelessness*, 18 SOCIALIST REVIEW 1 (1988).

During *gentrification*, the neighborhood is rapidly "improving" as higher income people move in, owners rehab existing structures, and lower income people are displaced (or, if they stay, "shelter impoverished" by rising rents). Low yielding commercial and industrial properties are converted to high end residential use. The neighborhood is becoming homogeneously upper income. Values are increasing. Density is decreasing.

If we are mainly interested in the welfare of the lower income group in these scenarios, we can say that it is likely improving in the *filtering* scenario, in spite of the fact that long time residents view the neighborhood as declining. The welfare of lower income groups is likely declining in *downward tailspin* and *gentrification*. It is likely improving in *upgrading in place*, so long as modest rent increases reflect improvements that lower income tenants want and can afford.

To predict the distributive consequences of policy, we need to go beyond the surface characterization of change by reference to improvement/decline and rise/fall of property values in assessing when and how to intervene:

	Poorer Group Gains	Poorer Group Loses
Neighborhood Improves	UPGRADING IN PLACE	GENTRIFICATION
Neighborhood Declines	UPWARD FILTERING	DOWNWARD TAILSPIN

II. MACRO FACTORS, NEIGHBORHOOD ACTORS AND NEIGHBORHOOD DYNAMICS⁵

There are, roughly speaking, two sets of causal influences on the emergence of these types of change, the macro factors and the local factors.⁶ At the macro level, demand for housing from different groups varies with national or regional changes in income and its distribution, demographic changes (birth rate, household composition, migration), and changes in the cost of new construction, rehab and conversion to residential from other uses. Also at the macro level are changes in the demand for space from non-residential uses (industry, commercial, non-profit, government). Perhaps most important, there is a single national capital market, to which all local interest rates are tied.

Macro factors come to bear on particular neighborhoods through the mediation of neighborhood actors. These include local landlords and tenants. Although we are mainly preoccupied with the welfare outcome for the particular subcategory of poor tenants, we need to recognize at the outset that this group plays a distinctly subordinate role in generating the neighborhood changes that largely determine its fate.

Far more important, for example, are the federal, state and city governments, in so much as they adopt and try to implement public policies that affect the way the macro factors impact neighborhoods of different types, for example, through taxation, zoning or housing subsidies. These same entities deliver services to neighborhoods, from policing to snow removal. They are also proprietary entities, making decisions about construction and choosing locations for public housing and government service buildings.

5. A key text for understanding this set of issues is G. MYRDAL, *AN APPROACH TO THE ASIAN DRAMA*, 1843, Appendix 1 (1970). On the typology of actors, see Goetze, *supra* note 4.

6. For the purposes of this paper, "macro" factors are those that affect the city as a whole.

Commercial and industrial developers fall in the same proprietary category, as do non-profits like hospitals and universities that are major players in many large urban land markets. Local merchants and national retail chains make small land use decisions that can have large impacts. Along with public policy makers, public service providers, and the various proprietary entities, there are five industries—real estate development, brokerage, banking, building contracting and insurance, that make decisions on a neighborhood-by-neighborhood basis (taking into account and thereby mediating changes in macro factors) with big consequences for neighborhood outcomes.

The housing literature has developed the important concept of *neighborhood dynamics*. We use this concept to account for the fact that more or less identical neighborhoods react radically differently to the macro factors as mediated by the local actors. The changes in a given neighborhood that seem to have been provoked by exogenous changes at the macro level are often either far greater or far smaller than we would expect if all that counted was the macro level. Both *downward spiral* and *gentrification* as described above are examples.

The elements that make up the dynamics concept include: the notions of neighborhood effects of individual decisions by owners, renters, institutions and authorities; feedback loops, or circular causation, so that actors are affected by the reactions to their own actions; and areal factors, meaning that actors make choices on the basis of guesses about what will happen and contribute by their guessing both to unanticipated outcomes and to self fulfilling prophecies.

Some typical dynamics include *gentrification* and *downward spirals* as described above, but these are only the most striking. Another extremely important dynamic possibility is what we might call *hyperstable equilibrium*, meaning a situation in which the neighborhood system returns to its previous level of rents, amenity, crime, and so forth, even after there have been large shocks to the system from the outside. The neighborhood seems to be able to sustain itself in spite of a dramatic increase in unemployment, for example, or to return to its earlier equilibrium in spite of a massive injection of

government housing subsidies that had been expected to permanently raise housing standards. The notion of a *threshold* comes into play to describe the situation in which nothing at all happens to a system until the exogenous change reaches a critical point, after which *hyperstable equilibrium* shifts into another of the various modes.

The dynamics approach is not causal, at least not in the usual sense of the term. It identifies scenarios, like the four described above. Then it describes the patterns of interaction, between boundedly rational actors with imperfect information facing high transaction costs for coordinating their strategies, that can account for the scenarios. The dynamics approach does not explain the initial configuration of material circumstances, preferences, and strategic biases that is the precondition for the unfolding of the particular dynamic that occurs. Although it does not offer a full causal explanation for change or stability of a given neighborhood system, the dynamics approach does support common intuitions that *upgrading in place* can lead to *gentrification* and that *upward filtering* can lead to *downward tailspin*.

There is sometimes a significant zero sum aspect to neighborhood change of the kinds described. In *gentrification*, the renters in the poorer group lose, while equity owners, many of whom may be low income, gain, along with the upper income in-movers. *Upward filtering* will have negative consequences for residents who want to stay but don't like the changes in the neighborhood, but positive ones for existing owners, who receive more, when they sell to invaders, than they would have in a stable market. There are benefits for the lower income in-movers, and for renters (but not owners) in the neighborhood from which the in-movers came. *Downward tailspin* is likely to be bad for almost everyone, and *upgrading in place* good for almost everyone. The zero sum game to which the neighborhood dynamic is analogous may be a *prisoner's dilemma*. This is the case when homeowners in a neighborhood can sustain or improve the neighborhood if they all stay and invest in their properties, but an owner who stays and invests when the others begin to leave will lose most of the value of his home.

III. THE LEGAL CONTEXT OF NEIGHBORHOOD CHANGE⁷

In each of the four situations, whether *filtering* or *upgrading in place occurs*, who gains from it, and whether or not it leads to *downward spiral* or *gentrification* depends, to a significant extent, on the legal structure of the markets in question. Various legal regimes influence each of the neighborhood actors, in many different ways. Just as important, as we will see, each neighborhood actor has what we might call *legal cards*. The actor can play these legal cards along with other cards, such as sheer economic power, access to information, political clout, or whatever, in pursuit of the actor's objectives in the unfolding process of neighborhood stability and change.

We can distinguish between regimes *on paper* and regimes as enforced or not enforced *on the ground*. A regime as enforced has effects on the market. These effects may be intended or unintended, and they may be desired or undesired.

7. The discussion of the legal context is derived from the critical legal studies approach exemplified in a very general way by Duncan Kennedy, *The Stakes of Law or Hale and Foucault!*, in *SEXY DRESSING, ETC.* 83 (1993). For works that use an at least somewhat similar approach in the specific context of housing, see also GERALD FRUG, *CITY-MAKING: BUILDING COMMUNITIES WITHOUT BUILDING WALLS* (Princeton University Press 1999), WILLIAM SIMON, *THE COMMUNITY ECONOMIC DEVELOPMENT MOVEMENT: LAW BUSINESS AND THE NEW SOCIAL POLICY* (Duke University, 2001), Duncan Kennedy, *The Effect of the Warranty of Habitability on Low Income Housing: "Milking" and Class Violence*, 15 FLA. ST. L. REV. 485 (1987), Note, *Rent Control as an Anti-Gentrification Device*, 101 HARV. L. REV. 1835 (1988), Lawrence Kolodney, *Eviction Free Zones: The Economics of Legal Bricolage in the Fight Against Displacement*, 18 FORDHAM URB. L.J. 505 (1991), Keith Aoki, *Race, Space and Place: The Relation Between Architectural Modernism, Post-Modernism, Urban Plannig, and Gentrification*, 20 FORDHAM URB. L. J. 699 (1993), Richard Ford, *The Boundaries of Race: Political Geography in Legal Analysis*, 107 HARV. L. REV. 1841 (1994), Andrew Diedterich, *An Egalitarian's Market: The Economics of Inclusionary Zoning Reclaimed*, 24 FORDHAM URB. L.J. 23 (1996), Dmitri Evseev, *Making Mixed Income Communities Possible: Tax Based Sharing and Class Desegregation*, 114 HARV. L. REV. 1575 (2001).

There are two layers to the legal regime. One layer consists of *private rights* that are enforced by police and prosecutors through criminal law, and by owners, neighbors, tenants, and prospective owners and tenants through civil lawsuits. The other layer is the *regulatory overlay* of rules governing the interventions of regulatory administrative agencies like building inspectorates, Fair Housing bureaus, zoning boards, and the like.

A. Private Rights

When the invasion is defined as a crime, neighborhood actors can go to the police to get them to enforce their rights against adversaries. The police will often intervene first to stabilize the situation and then through arrest and eventual prosecution act to deter similar conduct in the future. Private right holders can also go to court (supposing they have the necessary information and other resources) to enforce private rights against other actors, public and private. The court may order the adversary to pay compensation for a past invasion of the right or issue an injunction requiring the adversary to respect the right in the future.

Just what the parties' rights are in the particular case is determined in the course of both criminal and civil litigation through the judge's interpretation both of highly specific particular rules and of general principles (both often contained in legislatively enacted statutes) and then the application of the rules and principles to facts found in the trial process. Within the universe of private rights, we can distinguish the set of rules that permit owners to control land (and tenants to control apartments), by authorizing the owners to repel trespassers and to object effectively when neighbors do things that injure them without actually invading their property (for example, by creating nuisances). Criminal law plays a large role in regulating conduct in this area.

Then there are the rules authorizing the transfer of property from one owner to another or from an owner to a renter. There are also rules authorizing the creation of enforceable contractual relations like those between mortgagors and mortgagees and insurers and insureds. In these situations, criminal law is relatively unimportant. Here the battle is between creditors, landlords or insurance claimants and their

civil adversaries, and the parties have to rely on self help or on the courts rather than on the police and prosecutors.

Formalities are requirements for making a transfer effective within the legal system. Besides formalities, there are many rules that are supposed to regulate housing markets. These rules regulate the terms and conditions of transfers; specify interest rates and foreclosure terms in mortgages; establish the consequences of giving incorrect information when entering an insurance contract; determine the validity of attempts to restrict in advance by agreement the use of land sold to another (e.g., by racially restrictive covenants); and, most important, regulate the terms and conditions of residential leases. These last rules concern the control of private evictions by landlords (by forcing them to go to court) and the requirement that leased premises meet minimum health and safety requirements.

The regime of private rights operates against public entities, governments and public authorities, as well as against private parties. State constitutions and statutes create rights against state and local governments. Federal statutes and the federal Constitution create rights that limit state and local governments. Finally, the federal Constitution creates rights against Congress and the executive branch of the federal government.

B. The Regulatory Overlay

As we have just seen, the regime of private rights does not simply authorize private parties to do what they want with their property or to transfer property to anyone they want under any conditions they want. There are many restrictions on actors within the private rights regime. These are enforced, if at all, when private parties use them against one another or against governmental entities. In response to violations, private parties may assert their rights aggressively by going to court for damages or injunctions. When private parties are brought into court, they can also assert their rights defensively by challenging the legality of statutes, official actions, specific transfers, or unilateral assertions of owner control.

The regulatory overlay creates official, public bureaucracies—federal, state and local—that are formally charged with enforcing distinct, but overlapping, sets of statutory regulations that reach the conduct of the different kinds of actors. Some typical examples are housing inspectorates that are supposed to enforce building, fire and sanitary codes; local boards in charge of enforcing zoning regulations; civil rights or fair housing agencies charged with enforcing anti-discrimination laws; public utilities commissions that are supposed to enforce rules governing hospitals and insurance companies; the divisions of HUD that implement federal public housing policy; the divisions of the Federal Reserve Board and the Treasury Department that are supposed to enforce various banking regulations; and local boards in charge of rent control regimes (where they still exist).

C. The Background Rules Thesis

The background rules thesis is that, to understand why we end up with *hyperstable equilibrium* or *upgrading in place* or *downward spiral*, we have to consider the ways in which the network of private rights and public regulations influences the conduct of neighborhood actors. But we do not assume that the legal system as a whole deliberately decrees one thing or another in the way of neighborhood change. Rather, we conceptualize the network as providing background rules that constitute the actors, by granting them all kinds of powers under all kinds of limitations, and then regulating interaction between actors by banning and permitting, encouraging and discouraging particular tactics of particular actors in particular circumstances.

We have to take into account that paper rules may or may not be enforced. For example, it is only to the extent that they are enforced that the rules governing landlord attempts to evict tenants by harassment, rather than by going to court with legal grounds, have any effect at all. But if they are enforced, they will affect what happens both in *gentrification* and in *downward spiral* situations, although these rules are not “about” either type of change.

Neighborhood change is definitely not the product of a large legal plan enacted and enforced from the center (Washington or the state capital or City Hall). But when neighborhood actors decide how

to react within the process of neighborhood change, they constantly factor in their legal cards—legal entitlements, legal liberties, legal resources, legal vulnerabilities, and so forth. The value of each card depends on how the player thinks that other players will react if it is played, and on what cards the other players hold.

IV. ILLEGALITY AND INFORMAL NORMS IN THE U.S. LOW INCOME MARKET⁸

So far, starting from the phenomenon of neighborhood change of various kinds, we have looked at macro factors, neighborhood actors, neighborhood dynamics, and the legal background. There is a final large structural feature of the system that we need to add to the picture, which is the overall distribution of the urban population into neighborhoods. First, neighborhoods are segregated by race and class. Second, neighborhoods display different levels of amenity and different relationships to the legal background. A major point of this section is that with respect to the dimensions of legality/illegality and formal/informal normative ordering, the United Statesean market is much more like typical third world metro regional markets than we United Statesean analysts generally recognize.

A. A Typology of Legality and Illegality in Metro Housing Markets

1. Three types of market

In *low income urban* housing markets in the United States, most units are "illegal," in the sense that they have multiple violations of the formal rules specifying minimum fire and sanitary conditions and rehab often violates building codes. Public and subsidized new construction complies with building codes, and usually with fire and

8. The discussion of informality is mainly influenced by the articles collected in *ILLEGAL CITIES: LAW AND URBAN CHANGE IN DEVELOPING COUNTRIES* (Edesio Fernandes and Ann Varley, eds., 1998). See also ROBERT ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (Harvard University 1994).

sanitary codes. Due to the high cost of compliant new housing construction, there is no private unsubsidized new construction for low income people.

The *middle and upper income urban* market for owner occupied and rental units is in compliance with the fire and sanitary minima without significant official enforcement; private rehab and new construction comply with loosely enforced building codes. But in these markets sellers and their agents routinely violate anti-discrimination laws, so that minority renters and buyers are routinely steered into predominately non-white neighborhoods.

The *suburban market* is under an effectively enforced zoning regime of requirements well above the legally specified minima for urban housing, but significant variances are granted by dispensing bodies, sometimes under conditions suggesting bribery. Here also there is widespread racial and class based discrimination in sales.

2. The interaction of illegality and informal norms in the low income market

The low income sector could be described as "illegal." A large proportion of units violate building, fire and/or sanitary codes. New units are created through subdivision of existing buildings in violation of building codes and zoning regulations. The situation of illegality is stable because city and state inspectorates are both unable and unwilling to enforce the regulations in low income areas and because tenants do not enforce their legal rights.

Under the formal legal rules, in most large urban jurisdictions, a tenant who rents premises that violate the codes has a right to force improvement to code; recover damages; and resist eviction for non-payment of rent. The technical doctrine varies from jurisdiction to jurisdiction but it is generally the case that a tenant represented by experienced legal counsel can use the legal rules to avoid paying any rent at all for long periods, or to force significant improvements of premises without increase in rent.

Tenants do not enforce their legal rights for a variety of reasons. These include ignorance of their rights, the frequent unavailability of free legal services, the prohibitive cost of private representation, and the fear that if they successfully sue the landlord,

he or she will improve the premises to Code, and then raise the rent. It is also the case that tenants and landlords operate in a situation of normative ambiguity.

The norm laid down in state law, the *formal* norm, is that the tenant who rents subcode premises has an armory of rights that will protect against eviction for non-payment of rent. This is the case even when the failure to pay has nothing to do with the condition of the premises, but is motivated, say, by the tenant's loss of a job or failure to manage income responsibly. This norm of state law is not clearly consistent with the societal norm. Landlords in general, and many tenants as well, are likely to subscribe to a contradictory norm requiring that if the landlord is delivering the premises as promised, and the tenant is occupying them, the tenant should pay what he or she agreed to pay.

On the other hand, when the landlord has rented the premises in good condition and then lets them deteriorate, there is no question that the formal norm that gives the tenant the right to retaliate through nonpayment corresponds to the norm of the general culture, or the *informal* norm. Moreover, the landlord may be opportunistically taking advantage of the tenant's development of an investment in staying put in order to exact the old rent for a deteriorated unit, one that would rent for less to a new tenant. The informal assessment is likely to be that, in this case, it is fine for the tenant to have rights that will allow him or her to in effect punish the landlord for misbehaving.

The important point for the economic analysis is that a tenant who rents a unit in subcode condition, for the going market rent for subcode units, may feel obliged to vacate the premises if he or she cannot pay that rent. The legal norm, according to which a tenant who contracts with full knowledge to pay the market rate for sub-code premises can default on that payment and resist eviction, may well be ignored because it violates the informal norm.

Given that most units in low income neighborhoods are subcode, and that neither tenants nor public authorities enforce the formal norms, it follows that market rents for many units are set on the basis of sub-code conditions. When a tenant successfully sets up defenses to non-payment or forces improvement, he or she is going

back on what both parties understood to be their agreement. If large numbers of tenants behaved in this way over a long time, rents would have to rise to correspond to the increased maintenance costs needed to keep the units up to code, and/or to correspond to increased default levels, if tenants simply skipped rather than forcing improvement. (All of the above supposing stable market conditions.)

3. The contrasting situation in urban and suburban middle and upper income markets

Landlords and owner occupants in middle income urban neighborhoods and suburbs provide tenants with a higher level of amenity for higher prices that are *absolutely* unaffordable for the poor. Tenant rights function to enforce the explicit or implicit contract in this situation. If the landlord fails to provide up to code premises, he or she is violating the actual understanding upon which the tenant agreed to pay the market rent. A tenant who enforces legal rights is likely to be able to afford counsel and is clearly complying with, rather than violating, customary norms by stopping payment or resisting eviction.

A significant component of this market rent reflects the value of the neighborhood, defined by things like public amenities, services, crime rates, etc. A neighborhood that is homogeneous in terms of race and income/class commands an *exclusivity premium*.⁹ For these reasons, identical units in different neighborhoods command widely different rents.

Rents including an exclusivity premium depend on the systematic violation of the formal legal norm of non-discrimination in the sale and rental of residential housing, and on the enforcement of exclusionary fiscal zoning rules that are designed to make it impossible to build or convert units in upper income communities to low income use. In other words, the statement that units in these neighborhoods are absolutely unaffordable for the poor is true only because of the complex interaction of illegal racial discrimination and constitutionally permissible class discrimination brought about

9. See Diedterich, *supra* note 7, at 55-57.

through zoning laws. Were it not for these two practices, *upward filtering* would almost certainly be far more prevalent than it is in fact.

As in low income neighborhoods, the relation between the formal legal norms (against racial discrimination and permitting class discrimination) and informal social norms is ambiguous. Private actions and suits by regulatory bodies aimed both at racial discrimination and at exclusionary zoning occur regularly, but on a scale far too small to have more than a marginal, warning-signal effect on practices and prices. On the other hand, it is likely that in the absence of formal law, even though only occasionally enforced, informal white norms of discrimination and preferences for segregation would be stronger than they are.

White social norms, like poor tenant norms about the obligation to pay market rents or vacate subcode premises, are contradictory and contested rather than clear. For example, attitudes condemnatory of racial discrimination can coexist with attitudes hostile to racial integration. Potential low income in-movers may simultaneously believe in their own right to move in and in the community's right to exclude "undesirables." Minorities are likely to disagree strongly with norms permitting racial discrimination that are widespread, though to some extent also contested, within the white community.

For the purpose of understanding neighborhood change, the key point is that in both low income and upper income neighborhoods there is widespread illegality. Practices on the ground do not in either case correspond to the norms of formal state law. Nor can such practices be said to correspond to a clear set of informal, non-state social norms. Formal norms are irregularly invoked in both sectors, and influence, without coming close to determining, market valuations in each sector.

B. Relative stability of the system

The United Statesean system taken as a whole, including legal and illegal elements in all sectors, might be described as *relatively stable*. That is, neighborhoods reproduce themselves as race and class

homogeneous through time, even though each of the four types of neighborhood change described in Part I is always going on somewhere. These neighborhood changes are followed by race and class homogeneity at a new equilibrium rather than by sustained chaos or by race and class mixing.

One intuitive economist's explanation of the pattern and of its stability is simple: the pattern represents a *stable efficient equilibrium*. This means that we interpret it as delivering to all participants an outcome that they prefer to the alternatives, *given their endowments*. This translates into three ideas: that the overall pattern of legality and illegality, along with the governing informal norms, adds up to property rights plus freedom of contract in most urban residential housing markets; that the poor get the housing they can afford; and that people prefer class/race homogeneous neighborhoods.

The rest of this paper pursues another type of economist's intuition: that the outcome can be understood as the product of a complex game, in which phenomena like *upward filtering* and *upgrading in place* are moves, and in which the definition of endowments is up for grabs, along with what can be gotten in exchange for them. In this view, the outcome may or may not represent an efficient equilibrium,¹⁰ but even if it does, it is most likely only one of several such equilibria. Its stability is a function of path dependence rather than of optimality as compared to its competitors.¹¹

For space reasons, I focus on the *upward filtering–downward spiral* dyad, but I think a closely parallel analysis could be made of *upgrading in place–gentrification*.

10. In the typical case, it will be impossible to decide one way or another.

11. For an introduction to this literature, see Mark Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996). See also Kennedy, *The Stakes of Law*, *supra* note 7; Duncan Kennedy, *Law-and-Economics from the Perspective of Critical Legal Studies*, THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 465 (Peter Newman ed., 1998).

V. UPWARD FILTERING AND DOWNWARD SPIRAL

A. *Upward Filtering*

The *filtering* concept helps account for activities within various housing markets. Starting at the wealthy end of the spectrum, *filtering* explains the building of dense middle income subdivisions in rich suburbs and the building of lower middle class apartment buildings in middle class urban single family neighborhoods. *Filtering* also explains the use of *blockbusting* to induce tipping as a mechanism of racial transition. Finally, *filtering* explains the subdivision of one and two family houses in lower middle class neighborhoods for rental to low income in-migrants, whether domestic (country to city, blacks from South to North) or international (current Asian and Hispanic arrivals in New York).

1. **Neighborhood housing market conditions that can trigger filtering**

a. **Push-out filtering**

Filtering occurs when low income individuals are pushed out of a low income neighborhood. Population pressure or rising relative incomes in a poorer neighborhood drive rents up to the point at which it is cheaper for some of the poor to move to the richer neighborhood, so long as they can rent low amenity units. The real income of in-migrants has fallen as a result of the price increase in the old neighborhood, but they have lost less than they otherwise would have because they can move out. In this case, prices in the richer neighborhood are likely to increase somewhat, as a result of *filtering*, counteracted by flight provoked by their arrival.

b. **Pull-in filtering**

Filtering also occurs when prices in a richer neighborhood decline to the point that it becomes attractive to those in the poorer

neighborhood. In this case, the poorer group gets an increase in real income as this desirable housing option becomes available. Price declines in the richer neighborhood are partially counteracted by upward pressure from in-migrants.

c. Non price changes

Filtering is triggered when the supply of external benefits increases in the richer neighborhood and/or declines in the poorer neighborhood.¹² For example, on the public side, external benefits include schools, parks, trash collection, public transport. On the private side, external benefits include the quality of supermarkets, banking services, insurance, etc. The supply of external benefits, along with crime rates, parking congestion, the property tax rate, and so on, affect the desirability of neighborhoods. Shifts in the relationships between all these factors can cause *filtering* of either the push out or pull in variety.

2. Neighborhood dynamics and *upward filtering*.

As we have seen already, we can account for what happens much more plausibly if we add to the supply and demand factors just listed the roles played by institutional actors, and the dynamic configuration of the neighborhood. Homeowners and developers doing conversions need credit from banks. Insurance companies have to decide whether to redline the neighborhood in response to apparent decline. It may turn out that the signs of *filtering* set off further changes that stall or reverse it.

The crucial point about the above description is that it is profoundly puzzling, from the point of view of the economic analysis that emphasizes efficient stable equilibrium under a regime of property rights and free contract, how there can be relative stability of a system of race/class segregated neighborhoods. It would appear that even in the absence of the kind of push/pull changes described above, there should be such constant *upward filtering* that no upper income neighborhood could exist for any length of time.

12. See Gerald Frug, *City Services*, 73 N.Y.U.L. REV. 23, 29-30 (1998).

Rather than representing an important special case, the scenarios in which owners in a higher income neighborhood develop sub-code units at high density should be extremely common. It should be possible to rent or sell them to in-movers from the lower income neighborhood at prices more profitable than retention of the land in upper income use. The best off of the poorer group should see moving as desirable in order to take advantage of the better amenities of the richer neighborhood, and to get the benefit of the exclusivity premium. Remember that the premium is paid for living with people of one's own or higher status.

For any given housing unit, the low income group will pay only a fraction of the dollars, per person, of what the group above them will pay, but if there were no enforcement of the formal norms in the low income market, developers could produce, through subdivision and new construction, the equivalent of slum housing in richer neighborhoods. Developers could bid the land away from upper income single-family large lot occupants based on the sheer numbers permitted by higher density, lower cost development.

Sometimes this is exactly what happens, and sometimes it is not. When it doesn't happen, it is often because access to legal institutions (rules plus enforcement mechanisms) allows upper income residents to resist successfully. This is obviously the case when an upper income community enforces zoning rules to exclude for "fiscal" purposes, or when a neighborhood gets officials to enforce anti-blockbusting regulations designed to prevent panic selling in response to *upward filtering* by minorities. But it is clear that there are many other legal norms, and social norms not re-institutionalized by the legal system, or contradicting legal norms, that come into play.

For example, in urban areas (as opposed to suburbs) the differential state enforcement of building and housing regulations may operate in a way equivalent to zoning, as in the New York City case with which this paper began.¹³ Here the play between legality and illegality has a particular distributive significance. Non-enforcement in

13. Salins, *supra* note 3.

the lower income neighborhood, combined with enforcement in the higher income neighborhood, functions to prevent *upward filtering*, rather than simply reflecting the preferences of the two groups given their endowments.

To the extent that both in-movers and prior residents see their interests as at stake in whether or not *filtering* is successful, they are likely to deploy a whole range of strategies that reflect norms of intergroup conflict in the setting in question. Prior residents may use a host of techniques of harassment, from ostracism to violence, to make in-moving seem undesirable to people who would otherwise be tempted by price differentials and to entrepreneurs contemplating arbitraging units from one market to another. In-movers can be expected to retaliate, at least some of the time.

These legal and illegal strategies are likely to affect whether *filtering* happens at all; and to affect whether or not filtering becomes *downward spiral*.

B. Downward Spiral

Implicit theories of the relationship between *filtering* and *downward spiral* seem to have considerable explanatory power in understanding the legal structure of residential housing in the United States, and to offer a way to relate the analysis of informality in third world urban housing markets to phenomena in the United States. The most basic intuition seems to be that a *freeloading filtering* is likely to cause a *downward spiral*.

Freeloading occurs when the lower income in-migrant is motivated by positive aspects of the richer neighborhood that would disappear if all the residents were of the lower income group. The freeloading in-migrant's benefit is thus dependent on others not following. The *downward spiral* is set off when the in-migrants deteriorate their new neighborhood to the point at which established upper income residents leave to escape them, thereby pushing down prices, attracting more in-migrants, which further deteriorates the neighborhood, which drives out more upper income residents, and so forth. The situation re-stabilizes when the richer neighborhood has become indistinguishable from the initially poorer neighborhood from

which the in-migrants came.¹⁴ In this situation, there is a direct conflict of interest between earlier and later in-migrants, as the later arrivals erode the gains of the earlier ones.

The *downward spiral* model helps in understanding rapid population movements such as white flight and the departure of the black middle class from the ghetto, and landlord behaviors such as *milking*—stopping maintenance while continuing to collect whatever rent the market will bear.¹⁵ It may explain (and be explained by) institutional behavior including systematic denial of credit by financial institutions; denial of homeowners insurance; sharp increases in auto insurance rates; and withdrawal of services by city government. *Downward spiral* is associated with myriad negative effects including arson for profit; “concentration effects” on social life as declining neighborhoods become more homogeneously lower class (e.g., increasing crime rates); corruption of bank lending officers and insurance agents; corruption of police departments by drug dealers; and widespread abandonment of physically viable housing stock.

What is most important from our point of view is that sometimes *downward spiral* follows *upward filtering*, and sometimes it doesn't. Once again, my argument is that the deployment of legal cards is an important explanatory factor.

VI. PLAYERS, LEGAL CARDS, STAKES, AND ARGUMENTS IN INVASION SCENARIOS

It is useful to see neighborhood change as the outcome of a complex interaction between the strategies of rival groups with conflicting interests that they pursue through *partial* ability to control both the formal regulatory legal process and the enforcement process.

14. Note that there is nothing necessary about this development: Schelling style tipping phenomena either happen or they don't—they are described but not explained by tipping theory, chaos theory, path dependence, or whatever, because these do not explain the underlying structure that produces the unstable equilibrium.

15. Kennedy, *The Effect of the Warranty of Habitability*, *supra* note 7, at 489.

Neither the legislative process nor the enforcement process is wholly responsive to any of the conflicting group interests. The effective regulatory outcome is a compromise.

A. The Players

Property interests include residential, commercial, industrial and institutional (governmental and non-profit) owners of land and buildings, and tenants from each of these categories. Their interests are complexly divided. Since some will benefit from invasion from below and some will lose, each player has to make a highly subjective estimate of how it is likely to fare under different scenarios (areal factors loom large here). Coalitions across property categories are likely (for example between a local hospital and homeowners fearful that invasion will destroy property values).

Service providers include the already mentioned categories of banks, insurance companies, brokerages, as well as government agencies delivering municipal services and non-profits.

Developers exploit the possibility of profit from moving lower income groups into higher income neighborhoods. They also exploit the possibility of profit from guaranteeing stakeholders against invaders. They operate on both sides of the conflict between stakeholders and invaders. In recent years, Community Development Corporations (CDCs) have come into existence as a new kind of player, functioning as developers but not for profit. Like private developers, CDCs have to have strategies, and these inevitably put them at odds with some of the players and in potential alliance with others.

Policy intellectuals, that is, people who are self-consciously theorizing the process of neighborhood change, operate in one way or another within all the institutions mentioned but also as neighborhood activists, in the local and federal government, and, at a distance, from academia. I would divide them, grossly, for our limited purposes here, into three types. *Neoliberals* have efficiency and growth as stated goals, usually to be achieved through the distributive interests of upper income groups and developers. *Public interest* oriented actors look for compromise solutions based on the idea that all groups have valid

interests. Their goal is to attain harmony—without hurting anyone too much—while promoting long term growth for the benefit of all. *Low income* (and often minority) oriented actors seek to improve the situation of the people at the bottom, usually poor tenants, through redistribution, to the disadvantage of richer groups, or through paternalistic regulation of behaviors they see as self destructive.

All parties fluctuate between recognizing and unrealistically denying the existence of serious conflicts of interests between and within higher and lower income groups; the possibility of massive unintended effects, particularly including the setting off of self-reinforcing change due to unstable equilibrium; and the radical disjunction between paper laws, enforced policy, widely shared informal norms, and norms that are contested among and within groups.

Each of the four kinds of player have access to the law making process and also to the enforcement process, but none controls it across the board. The poorer groups who benefit from *filtering* have such limited access to policy making that, for our purposes, we can simply ignore their contribution in that area. However, they can have a significant impact on enforcement practices and influence outcomes through legal or illegal self-help.

B. The Legal Cards

A player with access to the policy making process can try to enact new formal rules and then apply pressure of one kind or another for enforcement, in order to modify the outcome of the *filtering-downward spiral* process.

Exclusionary zoning rules restrict the neighborhood by requiring large lots and setbacks and impose occupancy limits to prevent *upward filtering*. *Inclusionary zoning* laws (in the *gentrification* context, the equivalent strategy is *linkage*) partially counter the effects of exclusionary zoning. *Anti blockbusting* regulations shut down realtors, prohibit signs in yards, and ban flyers that would facilitate *upward filtering* and possibly *downward spiral*. *Integration maintenance quotas* and *insurance of property values* in

racially unstable neighborhoods aimed to induce whites to stay and accept integration, thereby avoiding both *downward spiral* and possible substantial gains for invading minorities. *Private class actions* can be designed to persuade judges to change the formal regime of private rights for the benefit of one side or the other, for example, by effectively banning racial discrimination.

A quite different set of cards derive from the possibility of moving from illegality to legality by enforcing paper legal norms that may or may not correspond to social norms. *State enforcement* of existing environmental regulations, fair housing laws (prohibiting various kinds of discrimination) or building and sanitary codes, can transform existing *paper* norms into effective tools for preventing *upward filtering*. *Private actions* on behalf of tenants, through mass or selective individual representation, can enforce existing paper norms, as a strategy against *gentrification*.¹⁶

There is one other type of card to consider. Players with no access at all to policy making or enforcement mechanisms can resort to criminal or tortious violations of well established legal rules, for example by burning out in-movers.

C. The Arguments

1. Holders of Property Interests

Holders of property interests who think *filtering* will be bad for them argue that in-movers are:

- destroying the "character" of the neighborhood;
- reducing property values;
- increasing undesirable behavior;
- endangering the environment;
- increasing tax burdens;
- overburdening local government services;

16. See Kolodney, *supra* note 7.

- provoking class/race tensions that will lead to violence;
- provoking upper income flight that will lead to a *downward spiral*;
- violating building codes and fire and sanitary regulations and thereby endangering the whole community.

2. Developers

Developers use these same arguments to justify drafting land use restrictions designed to make *filtering* impossible, like restrictive covenants that function as zoning regulations.

Developers may be on the other side, allied with property interests that will benefit by *filtering*. Developers may ally with owner occupants who want to subdivide, or to move and sell for low income conversion, or with franchisors of drugstores or video stores who want to sell their products to in-movers. Coalitions of this kind argue in favor of in-movers on the free market ground that they are outbidding alternative uses—otherwise the problem would not exist—and by invoking the in-movers "right" to live where they can afford to build or rent, without "distortions" through regulation. They argue that their opponents schemes are a deliberate exclusionary device with illegal (race) or unsavory (class) discriminatory overtones. Furthermore, exclusion overburdens the areas that in-movers move in from, with all the bad consequences that stakeholders foresee for the invaded community: crime, bad environment, decreasing services, high taxes, race/class tension, and *downward spiral*.

3. Service Providers

Service providers, like developers and property interests, have to make the difficult calculation as to which way their interest lies. Banks, for example, have conflicting interests in neighborhood stability and neighborhood change, because they can write mortgages for those converting their units to lower income use, but this activity may undermine the security of the mortgages they wrote in the neighborhood when it was homogeneously middle class. Insurance

companies have to worry that state regulatory agencies will look askance at differential rate setting that may set off a political storm.

4. Policy Intellectuals

Policy intellectuals fit these lower level arguments into more abstract, ideological approaches.

Neoliberals find themselves in something of a bind, because their sympathy for top dogs in general conflicts with their customary antipathy to all regulation. With the occasional exception, they eventually come down on the side of exclusion of the poor from middle and upper income neighborhoods, through whatever legal means necessary. At the same time neoliberals argue for the repeal of the various kinds of restrictions on low income freedom of contract in their own neighborhoods that are supposedly the "real culprit" in the low income housing shortage.

In terms of their own analysis, it is impossible for neoliberals to determine whether the legal strategies of the players represent rent-seeking or the promotion of efficiency and investment, if the question is asked about the legal proposal in the abstract. Thus enforcing building and sanitary and safety codes may represent *internalizing externalities* or *securing the surpluses generated by exclusion*. The empirical investigation of this question would be of doubtful coherence and in any case practically impossible in any actual policy setting.

Public interest identified intellectuals, wherever they may be situated, try to devise compromises that can command consensus. But they don't have a principled or even a convincing pragmatic explanation of why either side should give in, except that everyone has to give in a little in order to avoid chaos. If compromise won't work, they go for one side or the other, according to whether they are really more identified with neoliberals or with low income identified actors.

Low income identified actors also find themselves in a bind. To proceed in a sensible way, it seems that they must first figure out whether the poorer group will in fact benefit by being permitted to invade, or rather will end up worse off as a result of a *downward spiral*. To answer this question they must take into account the possible gains from lower prices and possible losses from disregard of

paternalistic regulations (e.g. death by fire). Then they must decide what they think about the ethical/political justification for the redistribution that would ensue if *upward filtering* were successful and stable; whether there are bad long term economic growth consequences from permitting *filtering*; and if so, whether they counterbalance otherwise justifiable distributive gains. This inquiry seems to make more sense than the ones proposed (or elided) by the neoliberals and public interest actors.

D. The Stakes

It is impossible to predict *a priori* how these different legal strategies will play out. Until we know the actual situation, we will not be able to tell who will gain and who lose through new rules, enforcement of old rules, and illegality. We also cannot predict whether the legal intervention will cause, prevent or have no influence on unstable equilibrium phenomena like *downward spiral* and *gentrification*.

In the case we have been discussing, formalization through the enforcement of building and safety codes could function to stop *upward filtering*, to provoke *filtering*, to reduce living standards or to increase them, either as a result of redistribution from richer to poorer tenants or as a result of paternalist prevention of misfortunes like loss of life and limb caused by preventable fires, disease, and so forth. The neighborhood effects of each strategic intervention, that is its externalities, are equally incalculable—enforcement of formal norms in a situation previously characterized by illegality could either provoke or prevent a *downward spiral* and either provoke or prevent *gentrification*.

VII. CONCLUSION

This paper has attempted to integrate into a single model some of the insights of the neighborhood dynamics literature, the literature on informality, the path dependence strand in law and economics, and the critical legal studies analysis of the distributive effects of legal

background rules. A first hope is that such an effort might persuade neighborhood dynamics theorists that the playing of legal cards is a more important factor in the outcomes of neighborhood change scenarios than they generally recognize. A second is that it might persuade United Statesean analysts to apply to first world markets the analysis of illegality and informal social norms developed to describe third world settings. A third is to further the argument that legal/economic analysis will get further using the game theory approach, emphasizing unstable equilibria and path dependence, than by sticking to modeling stable partial equilibria. Finally, my aim has been to develop the background rules analysis of critical legal studies by contextualizing it.