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Memorandum

To: Tri-Valley Vision Community and Housing Committee
Policy Subcommittee

From: Peter MacDonald

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Subject: **Inclusionary Zoning v. Mandatory Set Asides**

The policy of mandatory set asides of rent controlled units increases the cost of new and existing housing. This memorandum reviews the economic events that cause the cost of housing exactions such as mandatory set asides to increase the general price level of new and existing housing. The policy implication is that we need to structure inclusionary requirements in ways that minimize increases in the cost of new housing. A further policy implication is that the most effective way to increase housing affordability is through real increases in the supply of entitled land.

Distinction between Inclusionary Zoning and Mandatory Set Asides

As a matter of definition, the concept of inclusionary zoning needs to be distinguished from the concept of mandatory set asides of rent controlled units. "Inclusionary zoning" as used herein refers to a local government requirement that a reasonable proportion of all new housing constructed meet higher density and/or smaller unit size criteria <u>at market prices</u>. Inclusionary zoning can be effective to increase housing supply and affordablility. "Mandatory set asides" as used herein refers to a local government requirement that new housing projects set aside a certain proportion of units with <u>rent controls</u> that extend far into the future. Mandatory set asides have the effect of decreasing housing supply and increasing the price level of new and existing housing as described below.

The Short Run Effect

At a recent meeting of the Policy Subcommittee of the Tri-Valley Vision Housing and Community Planning Committee, it was suggested that the additional cost of a mandatory set-aside would not increase housing costs, because the developer will deduct the cost of the mandatory set aside exaction from the price it will pay for the land, so the developer can still make its expected profit rate. The comment confuses the short run effects with the long run effects in economics. The comment also confuses the effects of exactions on the individual firm (developer) with their (cumulative) effects on the market as a whole.

Developers who have already purchased their land prior to unexpected imposition of a mandatory set aside requirement are just plain stuck. The entire cost comes out of their profit margin, as with Toll Bros. in East Dublin.

But, focusing on the individual developer's relationship to the entire market, consider, the situation in which ten developers have lands under option. Then, a mandatory set aside exaction is added to the cost equation. Some proportion of those potential projects are only marginally profitable and some of those options will be dropped. Typically, the projects which operate on smaller profit margins, such as apartment projects, will be the projects rendered infeasible. In Pleasanton, no market rate apartment projects have been proposed since the onset of mandatory set aside of rent controlled units.

Some landowners will refuse to lower their option prices while other landowners may acquiesce in land price reductions. The supply of housing is thus reduced in proportion to the non-acquiescing landowners. Also in the short run, mandatory set asides will have caused land values to decline for some landowners who, because of carry cost or alternative investment opportunities, are forced to absorb lower than expected land prices. But, in the long run, the cost of mandatory set asides will tend to migrate into the price level of new (and existing) housing, primarily by restricting the supply of entitled land. Here is how it happens:

The Long Run Effect

For the many anti-growth advocates and anti-growth cities, mandatory set asides are a way to fool the State regulators and others into believing affordability is being addressed while continuing to restrict housing supply. The background is that California governments and anti-growth advocates have become increasingly efficient at restricting the supply of potentially entitled lands (developable land) using legal tools such as urban limit lines, endangered species and wetland designations, general plan open space designations, large lot zoning, lengthy and uncertain approval processes, and critical infrastructure constraints (such as planned scarcity of sewer and water capacity). However, increased scarcity means the owners of the increasingly scarce developable lands which remain have greater market leverage to impose their desired price upon developers and ultimately housing consumers.

Any substantial increase in the cost of producing a house, such as a mandatory set aside exaction, pits the landowner's elasticity of supply of land against the housing consumer's elasticity of demand for housing. The developer is the middleman negotiating with each side and determined to achieve its "hurdle profit rate" or more. The long run issue is whether the increased cost of mandatory set asides will be reflected in lower land costs or in a rising price level for housing.

In the Bay Area over the last 30 years (since local government assumed management of the housing supply in the mid 1970's), all increased municipal fees and exactions have been reflected in higher price levels for housing and, in addition, land costs have actually increased their proportion of the cost of a new home at the same time. In other words, all cost increases have been absorbed by housing consumers rather than landowners. This pattern alone would suggest further cost increases from mandatory set asides will also be absorbed into the price level of housing. Housing consumers are losing the "battle of elasticities" because housing is a necessity, like water, for which people will pay at virtually any price level. (i.e. Housing demand is highly inelastic.)

The owners of developable land, on the other hand, will typically compare the present value of their land with the expected future value of their land. When the carry cost is lower than the expected appreciation in land values, landowners tend to hold out in anticipation of higher future land values. This anticipated appreciation in land value tends to give landowners greater staying power than housing consumers while the impact of a new exaction is being absorbed by the housing market. In the Bay Area, landowners who wait (willingly or unwillingly) have typically been paid handsomely in price appreciation for their delay.

The bite of a new exaction restricts housing supply most when an economy is recovering from a recession. During recessions, housing prices often fall below the price of producing new homes. But as the economy emerges from recession, and housing demand exceeds existing supply, the surplus of home buyers will bid up the price of existing housing until the price level is sufficient to cover the cost of producing new homes, including the cost of mandatory set asides. In the absence of mandatory set asides, housing production will pick up again at a lower price level, and will generate the supply which keeps housing prices from rising to the higher levels. This is notably the market phase when the cost of added exactions on new housing passes through into the price level of existing homes (i.e. the long run effect).

Cost/Benefit Problem

Even if the total cost increases from mandatory set-asides were exactly equal to the value of rent subsidies generated, the cost/benefit ratio of mandatory set asides is still extremely poor, because of their impact on the price of existing housing. A city with a 1.5% annual growth rate will have to impose fifteen percent (15%) mandatory set asides on new housing for ten years before even two percent (2%) of its households get to live in rent controlled housing. The resulting higher price level for market rate housing takes effect during the first few years and raises the cost of housing for the ninety-eight percent (98%) or more of the population who do not live in subsidized housing. Once the exaction price is passed through to existing housing consumers, even the households in income brackets eligible for subsidy will pay more, as a group, in housing costs than if the mandatory set asides were never enacted. Mandatory set asides create a lottery with housing consumer's money in which, overall, the unsubsidized housing consumer pays $13 in increased housing cost for every dollar of rent subsidy which is generated ("An Economic Analysis of an Inclusionary Zoning Ordinance" MacDonald, 2000, at www.macdonaldlaw.net).

Specific Effects of Mandatory Set Asides

Mandatory set asides, in themselves, decrease the supply of entitled land and increase the price of housing in several direct ways:

First, land, by itself, lacks substantial value until it is converted into entitled land, through the processing of plans and installation of massive infrastructure. Thus, the supply price of entitled land must reflect all the costs necessary to make that land entitled, including the "hurdle profit rate" for land owner/investors.

Consider the conversion of raw land into entitled land. In the case of East Dublin, that process took 18 years between land purchase and the first building permit. If rent controls from mandatory set asides are now the end result of the land development process, investors will be most hesitant to take on the long term costs of the land entitlement process only to have their planned profit expropriated "for public benefit" by politicians using the rent controls of mandatory set asides. The supply of entitled land will be reduced accordingly.

Second, another potential source of entitled land is increased density within the existing city. A critical source of supply for such new entitled land would be redevelopment. However, the rent levels for existing buildings will increase generally in proportion to the price increase for new housing. These existing buildings are not subject to the burden of mandatory set asides or other increases in municipal exactions. As a result, the additional cost burden of mandatory set asides upon private redevelopment projects will make many otherwise feasible private redevelopment projects infeasible. In this way, mandatory set asides will restrict the supply of entitled redevelopment lands.

Third, mandatory set asides create new uncertainty in the processing of housing projects, as neighbors, planners and politicians fight over the acceptable design, unit mix, and terms for incorporation of subsidized units in to projects. Rational developers will increase their "hurdle profit rate" to compensate for this additional delay and uncertainty, thereby restricting the housing supply in that proportion.

Fourth, the nonstandard production of scattered inclusionary units in a subdivision or apartment complex adds substantially to the cost of design, construction, and administration of projects.

Fifth, in many localities such as Pleasanton, local governments deduct the mandatory set aside units from the permissible density of the proposed project. This, in effect, is a reduction in the supply of entitled land. This density reduction also increases the return required from each remaining market rate unit before a housing developer will undertake a project.

Sixth, the institutional buyers of developed real estate, such as apartment complexes, will be hesitant to buy projects with subsidized units, in light of the regulatory difficulties and costs typically associated with rent controls. The problem of selling projects with rent controlled units will restrict the willingness of developers to undertake such projects until there are higher returns from the market rate units in potential projects (i.e. higher rent levels).

Seventh, mandatory set-aside requirements represent a different kind of exaction: a non-nexus exaction. Housing consumers are being asked to pay for mitigation of a housing shortage that they did not create, but was created by the very governments now attempting to solve the problem at the expense of that housing consumer. Previously, exactions have been limited to traffic, utilities, parks, schools and other facilities that actually serve the housing consumer. The funding of a general societal need from the price level of housing portends far greater uncertainty in the cost of future housing projects. One can imagine a myriad of unmet "public needs" such as downtown enhancement, urban forestry, cultural arts, and sites for churches, all of which could be foisted upon new housing consumers. The Alamo Creek project in Contra Costa County has just been approved subject to a condition that requires an $8.5 million payment for a "livable communities program." Rational developers must now include a big contingency in their financial projections to cover a rapidly expanding government appetite for non-nexus exactions.

Because of the project specific cost increases associated with mandatory set-asides, it is highly probable that the cumulative cost increases upon new market rate homes in a project far exceeds the cumulative value of the rent subsidies generated by the mandatory set asides. It should be remembered that it is the increase in costs, not the value of subsidies, that determines the resulting increase in the price level of housing.

Current Situation

Much of the entitled land in California is just now being subjected to the short run price reducing effect of mandatory set asides for the first time. (The first government bite at socialization of land values comes cheap to the government, but not to the landowner/developer.) All Bay Area governments are now in the process of adopting General Plan Housing Elements and are being pressured to solve the affordable housing problem through mandatory set asides. The Davis administration is mouthing concern about possible impacts upon the cost of market rate housing, while allowing communities to implement mandatory set asides. This is in contrast to the Wilson Administration which systematically rejected local Housing Elements with mandatory set asides because of their adverse impacts on housing prices. A mass movement of Bay Area cities into rent controls is bad for housing prices because it is the cumulative effect of many jurisdictions imposing mandatory set asides which will move the Bay Area price of housing even further upward.

The Breaking Point

There is a nightmare scenario under which some portion of a new exaction may be passed back to landowners in the long run. At the price point where household incomes no longer qualify buyers to obtain mortgages to purchase homes, demand is thus constricted. At that price point, housing demand becomes more price responsive (i.e. price elastic). The vastly overpriced California housing market is at or near that breaking point of affordability. For the fourth quarter 2001, less than twenty-five percent (25%) of Oakland PSA households can afford the median priced home. For the same time period, in more than eighty percent (80%) of U.S. metropolitan areas, the median household income will purchase the median priced home. (Housing Opportunity Index, at www.nahb.com). More than half of the 35 U.S. metropolitan areas in which the median household income will not purchase the median priced home are located in California, including virtually the entire urban population of California. The California policy of entrusting housing needs to local politicians has been a disaster for the California housing consumer.

At the extremely high housing prices of the Bay Area, the addition of expensive new mandatory set asides throws the existing dismal balance between supply and demand out of equilibrium. If housing consumers simply cannot absorb further price increases, equilibrium may then be reestablished in two ways: lower land prices or lower housing demand from emigration and slower growth.

Equilibrium can be reestablished if households, and the firms which employ them, choose not to locate in the Bay Area. That appears to be happening. For the nine county Bay Area, the very epicenter of the rapidly expanding world high technology industry, population has been growing at a slower rate than the entire U.S. population. During the 1990's, Bay Area population grew only 12.6% in contrast to U.S. population which grew by 13.2%. So, who says growth control does not work? The cumulative effect of widespread local growth controls has worked to control growth by substantially lowering the living standard of new and relocating households through higher housing prices. Growth control works by lowering the living standard of the entire next generation of Californians.

Another way equilibrium is reestablished is if land supply is increased (i.e. land prices decreased) when landowners find there is not sufficient demand to support their asking prices. But again, land prices will decrease only to the extent landowners believe that future land price appreciation will not be higher than their alternative investments. To the extent lack of effective demand caused by the additional exaction forces landowners to lower their asking prices, the cost of the exaction is passed back to the landowner, rather than forward to the housing consumer.

In the long run, the small portion, if any, of the cost of mandatory set asides which may be passed back to landowners can only be achieved by forcing Bay Area housing prices to the breaking point of affordability. At pathologically high price levels, housing demand and land supply finally become somewhat more price responsive. But, the primary effect of mandatory set asides will be to push housing prices up (from their near breaking point levels) while severely constricting the number of new housing units.

Conclusion

First, rent controls are an economically flawed solution to the problem of housing affordability. Second, inclusionary requirements based upon mandatory set asides need to be reformulated to minimize their impacts upon the price level of housing. And, third, the most realistic way to improve housing affordability is to increase the supply of entitled land.

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