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Getting Inclusionary Zoning Right

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The laws of supply and demand—and the need for neighborhood evolution—still apply when communities try to boost their supply of affordable housing.

More than 500 communities in the United States have adopted inclusionary zoning ordinances as at least a partial cure for their housing affordability deficits. Anyone who has an interest in places that have adopted a version of such zoning laws as a cure for prices so high they are placing an unacceptable burden on the budgets of all but higher-income households should be aware that, unless carefully structured, the ordinances may further limit the supply of new housing, exacerbating the affordability problem they were intended to cure.

The most obvious way this happens is when the ordinance sets the requirements for the number of below-market-rate units to be included so high—and the prices mandated for the units so low—that the returns to investors in market-rate housing are dropped to the point where building new residences is at best discouraged or, at worst, made infeasible. Such a counterproductive result should be avoided by testing the provisions before enactment and setting the rules for the number and prices of the inclusionary units to levels that will maintain development feasibility. However, crafting provisions in line with what is learned in such testing will not avoid a second counterproductive effect, which would be to restrict the process of neighborhood change. The intent of such restrictions is usually to avoid the displacement effect of gentrification.

I recommend that instead of targeting gentrification, the advocates of residential social justice should call for the enactment of laws that mitigate or prevent the displacement of long-term residents rather than to attempt to freeze the social and physical structure of neighborhoods.

The extraordinary escalation of housing rents and market values that is often referred to as the "housing affordability crisis" is not a phenomenon across the United States. Since the 1970s, residential rents and prices in America have followed three regional scenarios: regions with lagging economies where weak demand has kept prices from escalating; regions with vigorous increases in jobs and incomes where rents and home prices have been held in check by new and remodeled additions to the housing stock that equaled or exceeded demand; and regions where the cost of housing has risen as residential construction has been thwarted by hard-to-get, expensive, and time-consuming new construction and rehabilitation permits. Simply put, job-rich cities like San Francisco and New York have succeeded in making the laws and customs governing the right to build and remodel housing much more restrictive than they were before the last third of the 20th century, but they have not been able to alter the laws of supply and demand.

The mayors and other political leaders in economically prospering places with runaway housing prices are concerned that their middle-income and working-class households are having to spend well over 30 percent of their incomes to keep roofs over their heads. They are concerned, too, that the high cost of living in their towns is slowing the growth of their economies and preventing service workers without highly paid technical skills from moving into their communities. While their economies continue to enjoy a net increase in jobs, the fact that some well-paid jobs are being moved to less expensive places such as Provo, Utah, and Austin, Texas, also raises concern. None of these local concerns is

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trivial. An econometric model built by professors Chang-Tai Hsieh of the University of Chicago and Enrico Moretti of the University of California, Berkeley, calculates that between 1964 and 2009, increased costs primarily attributed to constraints to housing supply in cities like New York, San Francisco, and San Jose lowered U.S. gross domestic product (GDP) by 13.5 percent or $1.95 trillion. In the absence of housing-induced cost increases, their model predicts that, over time, employment in New York would increase between 179 and 787 percent, while jobs in the San Francisco Bay area would increase between 180 and 500 percent.

Harder to quantify, but very real, are the human costs of service workers being priced out of the area, workers being kept from accepting jobs in the region, and middle-class families leaving to obtain more space for their rental or purchase dollars. Little doubt exists that the mayors know that their concerns would be alleviated by significantly increasing the production of market-rate housing. Furthermore, they understand that, given prevailing market conditions, increasing the densities of permitted residential development and expanding the amount and pace of approvals for construction on vacant or underused residential sites would greatly and rapidly increase housing production. But a very good reason exists for why elected officials will turn a deaf ear to recommendations for such a strategy: they want to be reelected.

The political culture of cities such as San Francisco and New York would be unlikely to accept a market strategy for shooting down the rocket of higher housing prices. These cultures deny the relationships between supply and demand postulated by economists. The "not in my backyard (NIMBY)" faith has come to enshrine the belief that neighborhood rights trump citywide rights, and that the laws passed to protect the natural environment and preserve what is truly historic should be used as shields to preserve the status quo. The strength of these cultures among local activists is reflected in the priority that the planning and approval processes consistently give to neighborhood "stakeholders" over city- or regionwide concerns. Rather than accept the difficult and probably impossible task of changing the culture of their voters, mayors and their fellow elected officials have turned to inclusionary zoning as a tool to cure the chronic deficit in housing. Because providing housing for low- and moderate-income households is an almost universally popular goal, their hope is that adopting land use policies that legislate the inclusion of housing affordable to households in those income categories will lead to the supply increases needed to reverse the path of rising housing costs.

In addition to using the tool of a test to craft the provisions of inclusionary zoning to avoid inhibiting the flow of private funds to new construction, local government must avoid coupling the rezoning with the stultification of neighborhood change. In fights over additions to and renewals of the housing supply, the understanding of the positive role long played by the neighborhood change process has turned negative and been pejoratively renamed "gentrification." Whatever it is called, that process has been how cities and towns age healthily as structures and their functions alter with time. Historically, the process of neighborhood change has accounted for a significant share of the development of new and rehabilitated housing that leads to "downward filtration," delivering vacant used housing to those who cannot afford the price of new housing. This has been true since the first settlement evolved into a city. Ironically, many of the neighborhoods that activists fight to freeze were developed through the neighborhood change process that would today be labeled gentrification. In his 1880 book *Washington Square*, Henry James had his affluent character Arthur Townsend describe the demand support for what could be termed "upward filtra-

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tion." As Townsend remarked, "At the end of three or four years, we'll move. That's the way to live in New York—to move every three or four years. Then you always get the last thing."

Coupling the justification for inclusionary zoning with the vilification of gentrification is akin to announcing there is no need to patch the roof while warning that rainstorms are expected. I live in a mid-rise condo and know that a percentage of my neighbors obtained price bargains because they qualified for moderate-income status. After living in the building for over seven years and having served as president of the homeowners association, I cannot tell you who they are, nor do I care who they are. The development adjoining the one I live in was approved subject to the condition that it provide housing units for the tenants who had occupied an older building on the site before it was demolished. If that is a problem for anyone other than the developer, whose profit was cut by the arrangement, I have yet to hear about it.

From my experience and judging by what is reported from other neighborhoods in the United States and the United Kingdom, neighborhood change is not undesirable in itself unless it displaces long-term residents. Therefore, what is to be avoided is not new construction but rather the displacement of existing residents. The cause of social justice can best be served by policies such as granting existing tenants priority occupancy of below-market-rate units built in response to inclusionary rules, or the right to remain in the neighborhood for as long going forward as they have lived in the neighborhood, unless they prefer to accept compensation in the form of cash to allow them to obtain the housing of their choice. Rights along the lines of this suggestion should be granted within the inclusionary zoning act or in accompanying legislation.

In 1819, Chief Justice John Marshall wrote in one of the most fundamental U.S. Supreme Court decisions, "The power to tax is the power to destroy." The same dictum applies today to the power to calibrate the rules about the percentage and distribution of housing among categories of low- and moderate-income households. If the percentage of below-market-rate units is set too high and the income of people allowed to buy the below-market-rate housing is set too low, the return from the project will not be high enough to attract the funds needed to build it. However, if the rules set the percentage of below-market-rate units too low and the incomes of those who will be allowed to buy them too high, the investors and the developer will make excessive profits from the construction and lease or sale of the development. If used with care—and with an understanding of the relationship between the net returns to the project and the value of the site—the tools of real estate investment and marketing analysis can be used to get very close to that sweet spot between infeasibility and excessive profits. The process of using these tools is iterative, something that can be done efficiently with the use of computer spreadsheets.

The first step in searching for that sweet spot is simple in concept but rather tedious in execution, requiring projecting forward the likely income stream from the sale or rental of the unit for each combination of low- and moderate-income households allowed to purchase below-market-rate units. Listed below are the major categories of households in the income categories used in California. The complete list of categories includes further breakdowns based on family size.

▷ **Extremely low-income households:** 30 percent of county median income.

▷ **Very low-income households:** 50 percent of county median income.

▷ **Low-income households:** 80 percent of county median income.

▷ **Moderate-income households:** 80 to 120 percent of area median income (in California, this is typically the county median income).

The price or rent for one unit within each of the listed categories can be estimated by multiplying the median of the incomes within each of the categories by 30 percent. As a practical matter, the analyst would create a template that performs this multiplication for each category so that it can easily be calculated and put into the calibrating model for the rents or prices that would be paid for all the below-market-rate units over, say, the first 12 years after completion of the project. The same projection would be done for the market-rate units. The projections for all groups should include any estimated annual increase. The resulting stream of income would then be discounted back to the beginning of sales or rentals of the housing at a rate equal to an agreed-upon return on the equity required to fund the project. Opinions as to what is a reasonable rate of return on investment can be expected to differ, and reaching agreement on this percentage figure may not always be easy. In some situations, it may make sense to award approvals competitively based on the return rates accepted by would-be developers.

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The timing and amount of all the costs associated with the entitlement, design, financing, and construction, including builder's profit and land, would then be estimated and put into the model to test for feasibility by calculating whether the present value of the revenues equals or exceeds the present value of all the costs. The estimate of land costs is more complex when the project is subject to the rules of inclusionary zoning than in the case of a standard market project because the market tends to value land as the residual that remains after all other development costs, including an adequate return on investment, are covered. If good comparables within the same neighborhood or submarket from privately built market-rate-priced or market-rate-rented housing built in conformity with the "as of right" existing zoning are available, they can be used to estimate land value. If such comparables are not available, it may be necessary to conduct a land residual analysis using the costs and revenues from market projects in the same submarket to estimate the land costs to be put into feasibility testing of inclusionary zoning projects.

Estimating inputs for the costs and revenues of projects required to provide alternative amounts of below-market-rate housing affordable to alternative categories of low- and moderate-income households is not a trivial task. But, if the housing construction made possible under inclusionary zoning is to significantly improve the political economies of U.S. cities and the nation, zoning rules must pass the tests of feasibility and fairness. UL

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The Economics of Inclusionary Development

A new report from the ULI Terwilliger Center for Housing, *Creating Workforce Housing in Strong Communities: Incentives for Inclusionary Development*, blends financial modeling, graphic illustration, and policy analysis to describe the impacts of inclusionary zoning (IZ) on land values and development feasibility. The study also provides practical advice on how cities can optimize their development incentives, including tax abatements, density bonuses, and reduced parking requirements, to engage the private sector and ensure that IZ policies achieve their goals.

"We believe that for at least as long as real estate development remains robust in the current economic cycle and housing affordability for the workforce remains a priority for business and political leaders, IZ concepts will be part of local land use policy making," says Stockton Williams, executive director of the ULI Terwilliger Center for Housing. "The question then becomes: how can an IZ policy be best designed to work in the context of the local real estate development market? Our study is intended to help local officials come to more-informed conclusions in collaboration with their development community." Copies will be available at http://uli.org/research/centers-initiatives/terwilliger-center-for-housing/research/.