

NHC Affordable Housing Policy Review

VOLUME 3 • ISSUE 1

NATIONAL HOUSING CONFERENCE

FEBRUARY 2004

Inclusionary Zoning: The California Experience



The United Voice for Housing

NHC Affordable Housing Policy Review

NHC Affordable Housing Policy Review seeks to offer a balanced nonpartisan view of complex housing policy issues. This publication encourages discussion and commentary from all who choose to engage in a responsible dialogue on the housing needs of this nation. Published on an occasional basis, *NHC Affordable Housing Policy Review* provides insight into NHC's positions on key housing concerns and also includes other housing industry policy perspectives.

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NHC Affordable Housing Policy Review is published by the National Housing Conference (NHC), a nonprofit 501(c)(3) membership association dedicated to advancing affordable housing and community development causes. A membership drawn from every industry segment forms the foundation for NHC's broad, nonpartisan advocacy for national policies and legislation that promote suitable housing in a safe, decent environment. NHC members consist of nationally known experts in affordable housing and housing finance, including state and local officials, community development specialists, builders, bankers, investors, syndicators, insurers, owners, residents, labor leaders, lawyers, accountants, architects and planners, and religious leaders. **NHC is the United Voice for Housing.**

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The California Affordable Housing Law Project of the Public Interest Law Project is a nonprofit California corporation that provides statewide support, including litigation, policy advocacy, consultation and training for local legal services and other public interest law programs. Our areas of expertise include housing, public benefits, health and civil rights. Our housing attorneys specialize in land use and planning, state housing element and redevelopment laws, and preservation of affordable housing units.

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The California Coalition for Rural Housing (CCRH) is a statewide network of nonprofit housing developers, legal service providers and public housing agencies that support the production of decent, safe and low-cost housing for rural and low-income Californians. CCRH advocates at all levels of government and provides technical assistance to community groups and nonprofits on housing issues.

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Inclusionary Zoning: The California Experience

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Inclusionary Zoning: The California Experience

Introduction

By Nico Calavita

The impetus for the publication of this review was provided by the recently released report, *Inclusionary Housing in California: 30 Years of Innovation*, authored by the California Coalition for Rural Housing and the Non-Profit Housing Association of Northern California. This report confirms what many observers had suspected all along, that during the recent past the number of inclusionary housing programs in California has proliferated. No data had been collected since 1996. At that time, there were 75 inclusionary housing programs in California (Calavita and Grimes 1998). According to this new survey, as of March 2003, there were 107 cities and counties using inclusionary housing in California, one-fifth of all localities in the state. The City of San Diego adopted inclusionary housing in the summer of 2003, the largest city in the country with inclusionary housing, too late to be counted. At least a dozen more cities are considering inclusionary housing, including Los Angeles. Clearly, inclusionary housing has emerged as a powerful tool to expand the supply of affordable housing in California. At a time when public sector subsidies for affordable housing are even more limited in a context of skyrocketing housing costs, a market-based approach such as inclusionary housing is all the more appealing.

With inclusionary housing, construction of low- and moderate-income housing is linked to construction of housing in the marketplace, by mandating developers to provide the affordable units in an otherwise market-driven development. In doing so, inclusionary housing not only generates units affordable to low- and moderate-income families, but also provides opportunities for racial and economic integration. With inclusionary housing, affordable housing units are built concurrently with market-rate housing, sidestepping community opposition to the siting of low-income housing within their boundaries.

Inclusionary housing programs originated in the Washington, D.C metropolitan area in the early 1970s when Fairfax County, Virginia and Montgomery County, Maryland adopted inclusionary housing. Fairfax County's ordinance was invalidated by the Virginia Supreme Court, but the County subsequently modified the ordinance, which has been in successful operation for almost 15 years. In contrast, Montgomery County's Moderately Priced Dwelling Unit program has been hugely successful, producing more affordable units than any other single local government in the country.

The program that has generated the most visibility and controversy at the state level is the court-mandated inclusionary housing program in New Jersey. With the landmark 1983 Mount Laurel II decision, requiring local governments to use "affirmative governmental devices...including...mandatory set-asides," the New Jersey Supreme Court forced recalcitrant localities to address economic and racial integration through fair-share housing plans. In that context, inclusionary housing has become the central component of almost all regional fair-share plans in New Jersey.

In Massachusetts, the 1975 Zoning Act, popularly known as the “anti-snob zoning” law, allows developers to sidestep zoning and other regulations when proposing affordable projects in communities that have failed to produce their “fair share” of such housing. This provision has helped provide affordable housing, but not as much as “true inclusionary housing” could provide (Ziegler 2002).

Outside the New Jersey Supreme Court-inspired inclusionary housing then, California appears to be the leading state in fostering inclusionary housing programs that are locally and voluntarily adopted. As such, the California experience needs to become an integral part of the current debate on inclusionary housing. The housing crisis, especially acute in certain parts of the country, and declining government resources fostered by huge budget deficits at the state and federal levels, make inclusionary housing an increasingly appealing mechanism to produce affordable housing in other jurisdictions as well. The California experience can significantly contribute to that debate and provide invaluable lessons for states and localities contemplating inclusionary housing. In addition to the aforementioned report, another recent California publication that has addressed inclusionary housing in California is the *California Inclusionary Housing Reader*, published also in 2003 by the Institute for Local Government, the research arm of the League of California Cities. The goal of the *Reader* was to “help community leaders evaluate whether inclusionary housing ordinances are for their community” (page iv). The *Reader* does not advocate inclusionary housing, but it certainly legitimizes it in the eyes of local jurisdictions, and goes as far as providing a sample inclusionary housing ordinance. Inclusionary housing has definitely arrived in the Golden State.

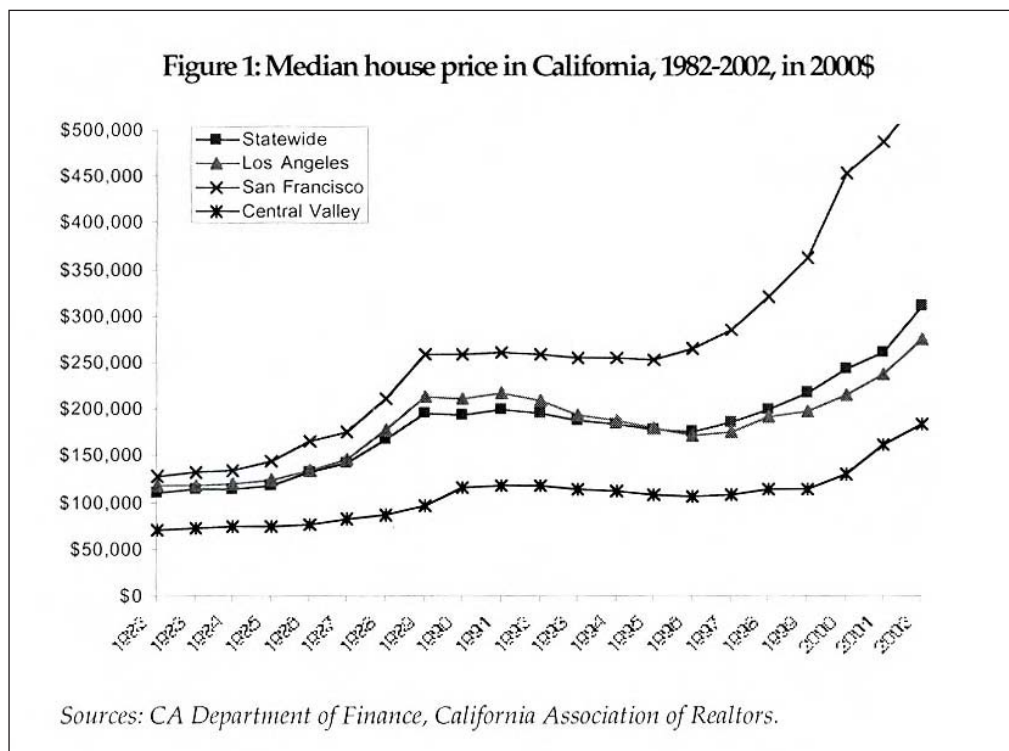
With this publication, the 30-year experience of inclusionary housing in California is brought to the attention of a national audience through the sponsorship of the National Housing Conference. It attempts to provide a concise, comprehensive, up-to-date, state of the art account of inclusionary housing in California. It is organized as follows: First, the origins and evolution of inclusionary housing are presented, together with a discussion of the controversy surrounding inclusionary housing, especially the issue of who pays for its costs. Second, the findings of the 2003 survey are presented, followed by a brief analysis of the constitutionality of inclusionary housing. The report concludes with an analysis of the market implications of inclusionary housing.

Origins and Evolution of Inclusionary Housing in California

By Nico Calavita

Origins

The primary reason behind the spread of inclusionary housing programs in California is high housing costs. The upward spiral in housing prices began after the recession of the early 1970s and has continued, almost unabated, ever since. The highest increases have occurred during the last five years, a time when inclusionary housing programs have proliferated. Since 1982, housing prices in the San Francisco Bay Area have risen more steeply than in other parts of the state, generating the largest number of inclusionary housing programs (see Figure 1).



Several factors have been cited as contributing to the rapid increases in housing costs in California.

- Heavy in-migration during the 1970s and 1980s, and the inability of the housing industry to keep up with demand (Levy 1991). While not fueled by in-migration as in the past, California will continue to grow rapidly adding more than a half-million additional people to its population every year for the next 20 years.

- NIMBYism. Successful opposition on the part of residents to new residential development-especially higher density-both at the periphery and in urbanized communities, limits housing construction (Fulton 1999, Myers and Park 2002).
- Declines in investment in public infrastructure at the state and local levels reduces the availability of developable land. One result is unusually high development impact fees. While the full amount is not necessarily passed on to consumers-fees tend to reduce land prices (Nelson and Moody 2003)-high fees usually result in higher housing costs. The main cause of the infrastructure deficit at the local level is Proposition 13, passed in 1978, that limited property tax revenues.
- Proposition 13 has another significant deleterious effect on the housing market. Fiscally impoverished cities engage in “fiscal zoning” that encourages commercial land uses that generate sales taxes while discouraging housing perceived as a fiscal drain because of the need for services that it generates.
- Many existing metropolitan regions such as Los Angeles and San Diego were developed on coastal plains and mesas. The remaining land is highly constrained from an environmental standpoint, especially in terms of slopes and biology. Natural habitat preserve systems developed under the statewide Natural Communities Conservation Planning Program (NCCP) preempt large tracts of land from development. In southern San Diego County, for example, the Multispecies Conservation Program (MSCP), the first program approved under the NCCP in 1991, preserves 172,000 acres of land.

In California then, market pressures, residents’ opposition to housing, fiscal zoning, and regulatory exigencies have reinforced one another to drive up the cost of housing. In August 2003, the median price of a single family home broke through the \$400,000 barrier reaching a record monthly high of \$404,870.

Policy Making Environment

California General Plan Law requires that all localities adopt a General Plan and that the “Housing Element” be certified by the Department of Housing and Community Development (HCD), the only General Plan element that requires state approval. The Housing Element is a five-year plan that makes adequate provision for the housing needs of “all segments of the community” and identifies potential housing sites “for all income levels” (Section 65583 of Government Code).

The problem is that, while incentives exist to have Housing Elements certified by the state-such as accessibility to state funds or avoidance of litigation-a certified element does not guarantee that affordable housing will be built. In 2003, a Housing Element Working Group was established with the assignment of producing a comprehensive package to reform Housing Element Law. All legislators who had introduced Housing Element related bills have agreed to put on hold their efforts until this working group completes its task. This effort represents the most promising attempt to date to reform Housing Element Law to make it more effective and fair.

In the absence of a clear state mandate, an overriding government structure defining inclusionary housing programs, strong fiscal incentives and compelling court decisions as in New Jersey, inclusionary housing programs in California are adopted locally and subject to the vagaries of changing state and local political and economic circumstances.

Evolution

During the late 1960s and 1970s, the desirability of growth was increasingly questioned, prompting the passage of growth limitation measures on the part of localities adversely impacted by growth problems (Reilly 1973). In California, several bedroom communities clustered in the San Francisco Bay Area passed growth control measures that limited the annual number of residential building permits. To ward off possible legal challenges to their programs, cities like Petaluma and Davis passed de facto inclusionary housing programs, by favoring developers that would include affordable units in their projects.

During the 1970s, the City of Irvine and Orange County passed inclusionary housing programs in response to a severe imbalance between jobs and housing, and subsequent legal challenges. These lawsuits sought to stop additional rezonings to job-producing land uses and to produce more affordable housing units. In both jurisdictions, the major landowner, the Irvine Company, was able to influence the process that led to the enactment of inclusionary housing programs that were extremely flexible and dependent on cost offsets. These included density bonuses, reduced parking standards and the availability of government low-cost financing such as Community Development Block Grants and Section 8 new construction assistance. While producing a large number of units, the two programs did not enforce resale or long-term affordability controls leading to the loss of the inclusionary housing units, a sobering lesson for future inclusionary housing programs.

In 1980, during the Democratic administration of Jerry Brown, the Housing Element was strengthened by mandating that the determination of local housing needs be based on the locality's share of the regional housing need. This language was interpreted by HCD as an obligation "to zone affirmatively for regional housing needs" (Burton 1981). HCD prepared a "Model Inclusionary Housing Ordinance" that was presented to local jurisdictions as an essential mechanism to bring their Housing Element in compliance with state law (Mallach 1984). About 30 inclusionary housing programs were adopted during the late 1970s and early 1980s, some of them outside the San Francisco Bay Area and Orange County. Inclusionary housing programs proliferated so rapidly in California at the beginning of the 1980s that an observer noted that "New Jersey adopted inclusionary housing but California implemented it" (Burton 1981).

In 1983, with the advent of the administration of Republican Governor George Deukmejian, HCD lessened its advocacy of inclusionary housing programs, reducing the ability of local policy makers and housing advocates to use state law as leverage to foster inclusionary housing programs.

During the early and mid 1990s, HCD's hands-off stance toward inclusionary housing turned into outright hostility. Overregulation became the culprit for the deep recession of that period and for high housing costs. Thus, inclusionary housing became "a constraint

or an exaction on new development” (Coyle 1991) and local governments were discouraged from adopting inclusionary housing. At minimum, a jurisdiction was to measure the potentially deleterious impact of inclusionary housing on housing development. Letters to jurisdictions considering inclusionary housing included the following: “While we cannot endorse this approach to facilitate lower income housing production, if the City has implemented a program that acts as a governmental constraint, the City must analyze the effect that the action has on housing development” (Badenhausen 1995).

Cities considering inclusionary housing at this time decided to create programs that would provide cost offsets to developers, including financial assistance and regulatory relief. Regulatory relief may include density increases, impact fee waivers or deferral, fast-track permit approval, reduced parking requirements, relaxed design restrictions (such as reduced street widths or setbacks) or other regulatory concessions. Cost offsets, however, did not weaken developers’ resolve to oppose inclusionary housing. In San Diego, for example, the value of the offsets was determined by an inclusionary housing task force and housing affordability requirements were based on the value of the offsets. Even though the industry representative agreed to such a conciliatory approach, the building industry repudiated it and fired its representative, effectively killing the proposal (Calavita and Grimes 1998).

During the early and mid 1990s, 30 new programs were passed, with all of them including either regulatory relief or financial incentives and 18 of them providing both. In 1996, there were 75 inclusionary housing programs in California (Calavita and Grimes 1998).

Beginning in 1996, a boom period for the California economy generated many jobs and not enough housing. It is generally accepted that a healthy balance between jobs and housing mandates one new residential unit for every 1.5 jobs created. But during the late 1990s, the number of jobs created vastly outnumbered housing construction. In San Francisco, the ratio was 6.5 new jobs to one new home; in Los Angeles six to one; in San Diego and Orange Counties, 4.5 to one; in Santa Clara and San Mateo Counties, 10 to one. Even worse, housing construction lagged behind the levels of the 1980s. During the 1990s, one housing unit was built for every 3.72 additional residents; during the 1980s, it was one housing unit for every additional 2.95 additional residents (Meyers and Park 2002). The result was skyrocketing housing prices and many more inclusionary housing programs approved in the state. In 1999, HCD softened its stance toward inclusionary housing, evaluating inclusionary housing programs in the context within which they were adopted and discouraging programs with standards so strict and inflexible that would actually discourage housing production.

In 2001, the case of *Home Builders Ass’n v. City of Napa* 90 Cal.App.4th 188 was decided. As the contribution to this publication by Deborah Collins and Michael Rawson outlines, the Napa case established that inclusionary housing is a constitutionally valid extension of a jurisdiction’s zoning powers. This case is especially important because in California there are no laws that expressly authorize, require or otherwise place limits on the adoption of inclusionary housing outside of redevelopment areas and areas impacted by the Coastal Act. As such, the Napa case represents a watershed moment in the legal history of inclusionary zoning.

Developer Opposition, the Incidence Controversy and Cost Offsets

Not surprisingly, developers typically oppose inclusionary housing. They oppose it on ideological grounds, viewing it as an additional government intrusion in their affairs at a time when they feel besieged by government regulations and, especially in California, very high development impact fees. They steadfastly point out the seeming unfairness of inclusionary housing by maintaining that the costs they incur in building affordable housing units is passed down to homebuyers or renters of market-rate units, thus decreasing their ability to afford market-rate housing. Such a position, however, is highly controversial.

Economists point out that there are three parties who may bear the costs of regulations that increase the cost of development such as inclusionary housing, development impact fees and other forms of “exactions” that help mitigate the costs that development generates. Besides market-rate renters and homebuyers, developers and the seller of raw land to the developer can, under various circumstances, absorb all or part of the cost of exactions.

If the demand for housing is elastic, i.e. sensitive to changes in price, then developers will be unable to pass down the cost increases to homebuyers or renters and will have to reduce their profits. If developers do not own the land at the time of enactment of an inclusionary housing program or development impact fees, then they may bargain with landowners for a lower price.

These arguments have remained largely theoretical, but research on “incidence” (i.e., who pays the cost of exactions) is starting to emerge. In his analysis of impact fees, Yinger (1998) found that such fees led to a drop in the cost of land. Empirical work by Ihlanfeldt and Shaughnessy (2002) found that development impact fees reduced land prices by the amount of the fee paid, but also raised housing prices by half of that amount. This increase is open to interpretation and may be related to the benefits of the public facilities provided (Nelson and Moody 2003). Given the fact that inclusionary housing does not provide benefits for the homebuyers, this finding may suggest that inclusionary housing costs are passed backwards to the landowner only, but additional evidence is necessary. For now, it would be safe to concur with Watkins (1999) who “surmises that the impact fee will always be split between all the players in the development process” (Nelson and Moody 2003:6), with the respective share depending on the elasticity of the market.

To reduce the potential impacts of inclusionary housing on developers, land sellers or homebuyers, options that would reduce the cost of development such as cost offsets, incentives or alternative compliance can be provided. The contribution by David Rosen at the end of this publication, employed a land residual analysis to show that cost offsets can, under most market circumstances, make inclusionary housing feasible without affecting land costs or developers’ profits. More generally, Rosen’s piece demonstrates one way for local governments to assess the relative impact of inclusionary housing on development costs. Since the analysis is static relative to land prices, there is an argument to be made that absent incentives, the key input of land costs could decline within a city with a broad inclusionary housing policy.

Similarly, Hagman (1982) has argued that incentives and cost offsets keep land costs high. With land costs being the principal cause of skyrocketing housing prices in California, “the argument against inclusionary housing would probably lose much of its power if it became widely known that, in the long run, landowners and not homebuyers

bear the cost of inclusionary housing (Calavita and Grimes, 1998: 152). This issue awaits further research.

What follows is an excerpt from the report *Inclusionary Housing in California: 30 Years of Innovation*, authored by the California Coalition for Rural Housing and the Non-Profit Housing Association of Northern California. The report lays out the findings of a survey conducted by the two organizations in late 2002 and early 2003 to reassess the use of inclusionary housing practices across California. As of March 2003, one-fifth of all localities in California (107 cities and counties) reported using such practices. This represents nearly a 67 percent increase since 1994, when researchers first identified 64 inclusionary policies or ordinances. In addition to providing a snapshot of local inclusionary practices across the state, the article addresses key questions about how successful local policies implement inclusionary housing.

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Inclusionary Housing in California: 30 Years of Innovation*

*By the California Coalition for Rural Housing
and the Non-Profit Housing Association of Northern California*

Introduction

Over the last three decades, as the housing crisis in California has intensified and spread throughout the state, more and more communities have turned to inclusionary housing practices to create affordable housing for their residents and workers. It is an emergent trend in other states as well. As of March 2003, one-fifth of all localities in California (107 cities and counties) reported using such practices. This represents nearly a 67 percent increase since 1994, when researchers first identified 64 inclusionary policies or ordinances. At least a dozen other jurisdictions are in the process of adopting or considering adopting inclusionary housing.

Generally, inclusionary housing practices require or encourage developers to ensure that a certain percentage of a new residential housing project will be priced affordably. While not a substitute for a broader affordable housing strategy, inclusionary housing practices are generally thought to address economic and racial segregation by creating more economically diverse communities, particularly in suburban jurisdictions. By providing housing options for lower wage workers in high-cost communities, inclusionary housing can also help reduce commutes and address local mismatches between available jobs and housing supply.

In the absence of a statewide approach to inclusionary housing, each jurisdiction in California is free to choose whether or not inclusionary practices are needed or would be effective in that local context. This freedom has spawned virtually endless variation in program design, as each jurisdiction molds inclusionary housing practices to match its local needs and political reality. Although the term “inclusionary zoning” is sometimes used interchangeably with inclusionary housing, in fact, not all inclusionary practices are zoning overlays.

Given the pressing need for solutions, the diversity of inclusionary practice in California, and the increasing importance of inclusionary housing, the California Coalition for Rural Housing (CCRH) and the Non-Profit Housing Association of Northern California (NPH) conducted a survey to determine how local inclusionary housing programs are structured, as well as their relative effectiveness. The resulting report was intended to inform policy makers and the public about the central policy decisions in creating an effective inclusionary housing program. This understanding is crucial because inclusionary housing has the potential to create at least 15,000 units of affordable housing in California annually, nearly doubling the current rate of affordable housing production, according to the authors’ calculations. To date, inclusionary housing has created over 34,000 affordable homes and apartments in the state.

*This article is an excerpt from *Inclusionary Housing in California: 30 Years of Innovation* by the California Coalition for Rural Housing (CCRH) and Non-Profit Housing Association of Northern California (NPH). Additional information about the report is available online at www.calruralhousing.org and www.nonprofithousing.org.

Beyond the debate on the general fairness or advisability of inclusionary housing lies a set of practical questions and concerns for policymakers and advocates. What makes a program effective? What are appropriate goals for a policy or ordinance? What are the key variables or features in balancing developer concerns and community needs? In essence, what works?

In designing effective inclusionary programs, the most significant policy points are:

1. Size of the inclusionary percentage;
2. Income targeting of the housing;
3. Alternatives to construction on-site;
4. Developer incentives; and
5. Length of affordability.

The report addresses all of these key features, as well as presents examples and case studies to supplement the statistical profiles. While not offering a model ordinance or policy, the statistical profile and individual case studies provide powerful guidance to policymakers and advocates that can inform local planning and decisionmaking.

Central to all these decisions are a few key considerations. First, the political realities of adopting a policy or ordinance often pit for profit developers against “social-equity” advocates, with developers pushing for maximum flexibility and advocates striving for certainty. The extent to which developers actually have to produce the units or take actions to ensure production of an equivalent number of units depends largely on the flexibility of the program.

While alternatives may be crucial to ensure financial feasibility and political acceptability, too much flexibility can negate any positive policy impact. If in-lieu fees or land dedication requirements are set too low, developers will consistently opt out of construction. Allowing off-site construction and design differences threaten some of the potential benefits of inclusionary programs, such as simultaneous development of market- and below market-rate units, functional and aesthetic integration of affordable units into new neighborhoods, and minimization of neighborhood opposition. However, if builders cannot or will not build, then an inclusionary program is rendered virtually meaningless. Accordingly, program design and revision must consider both the benefits and potential limitations of each policy detail.

SMART GROWTH AND INCLUSIONARY HOUSING

Inclusionary housing practices relate to efforts to curtail sprawl and create “smart growth.” State law requires all jurisdictions to provide density bonuses as a means of incenting affordable housing. Such bonuses also encourage higher density construction, a key outcome for reducing sprawl and encouraging transit. Unfortunately, in practice, development standards such as high rear and front yard setbacks and parking requirements can undermine a developer’s ability to use the density bonus effectively.

The relationship to sprawl and growth is even more confusing in jurisdictions with “permit-metering.” In these instances, local policies or ordinances attempt to slow growth by imposing caps on the number of residential permits that be issued each year. This often creates a highly competitive permit application process in which affordable housing inclusion can become a bargaining tool, such as in Livermore or Morgan Hill. While the overall constraint on housing supply is problematic for affordable housing, the policies often attempt to mitigate the impacts by increasing the number of affordable units that are produced under these circumstances.

Research Methodology

CCRH and NPH initiated the 2002/03 survey to reassess the use of inclusionary housing practices across California. The survey questionnaire used in CCRH's 1994 study was modified, updated and expanded to include detail on housing production and other program features. Local advocates, planning officials and academics were consulted in these revisions and a final questionnaire was distributed by mail in early April 2002. All planning agencies listed in the California Planners' Information Network were contacted, including 58 counties and 467 cities (San Francisco is counted as both a city and county).



Map provided by Greeninfo Network.

To increase the response rate, two rounds of follow-up surveys were conducted. In June 2002, the questionnaire was again mailed and telephone contact was made with nonresponding jurisdictions reported to have local programs. In January 2003, a short follow-up survey was prepared and forwarded to responding jurisdictions seeking additional information on methodology for determination of in-lieu fees, total fees collected, income targeting goals and production numbers. In total, 98 jurisdictions returned completed questionnaires accounting for 92 percent of known programs in California. Based on previous studies and Internet searches of jurisdiction Web sites, another nine jurisdictions that did not return completed questionnaires are judged to have some form of inclusionary housing.¹

Findings

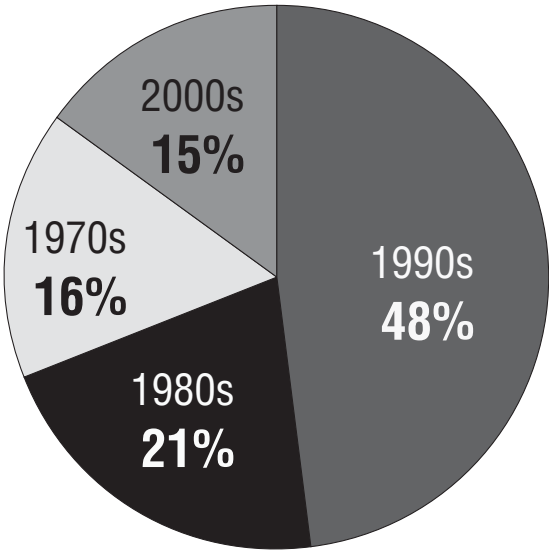
A. Number of Inclusionary Jurisdictions

As of March 2003, 107 California jurisdictions are known to use local inclusionary practices to provide affordable housing outside of the requirements of State redevelopment law. These include cities and counties that require affordable construction through an ordinance, general plan or permit approval process.² This list consists of 12 counties (21 percent of all counties) and 95 cities (20 percent of all cities).

The spread of inclusionary programs is most dramatic among cities, which represent 41 of the 43 new programs. As the map (see p. 11) clearly demonstrates, inclusionary housing is most prevalent in high-cost housing markets in the coastal counties. The most significant clusters are in the San Francisco Bay Area, metropolitan Sacramento, and San Diego County. At least two dozen other California jurisdictions are presently considering adopting inclusionary housing, including the largest city, Los Angeles.

Figure 1 shows the increasing popularity of inclusionary housing in the 1990s. Nearly half (48 percent) of all programs were adopted during that decade compared to about one-third (37 percent) in the 1970s and 1980s. The trend is continuing in the 2000s.

Figure 1: Year of Adoption



B. Measuring Effects on Affordable Housing Production

Although this report is primarily focused on providing a profile of inclusionary policies and ordinances, the survey also sought to gather data on affordable housing produced as a result of inclusionary housing practices. About one-third of known inclusionary jurisdictions reported production numbers accounting for over 34,000 units of affordable housing. In addition, 80 percent of all respondents believe that their inclusionary program has stimulated the production of affordable housing that would not have been built otherwise. For those jurisdictions that did not find inclusionary practices helpful in creating affordable housing, they generally agree that the principal barriers have been market stagnation or infrastructure limitations.

C. Forms of Inclusionary Policy

Inclusionary policies take the form of either a local ordinance, a General Plan policy, or a permit approval process that requires or rewards affordable projects. Seventy-eight percent of inclusionary programs are defined by a formal ordinance and 49 percent are prescribed in General Plans.³ In many cases, the two are linked; General Plan policies often charge or commit local government to adopt an ordinance.

Three jurisdictions (three percent of respondents) report no ordinance or General Plan policy, but have permit approval procedures that promote affordable production. These jurisdictions are Contra Costa County, Morgan Hill and Huntington Beach. Critics argue that this form of inclusionary practice is inadequate since it is not explicitly required at the individual development or project level. Instead, annual permitting targets are set or preferences established within a competitive permitting approval process. This leaves open the possibility that the more difficult-to-develop, affordable units will be delayed and approved at the end of the permitting period, thereby undercutting the notions of mixed-income housing and simultaneity of development. All three jurisdictions, however, report that the permit process regulations have provided affordable units that would not otherwise have been built.

While adoption of an inclusionary ordinance or General Plan policy is often needed to establish a clear program mandate, which of the two is more effective in terms of actual production is difficult to say. Certainly, the passage of a formal ordinance tends to impose inclusionary requirements in a more permanent and universal way (applicable to all developments of a certain size), with more formal procedures and specificity for implementation than does a General Plan policy. However, there was no statistical correlation between the relative effectiveness of an inclusionary housing program and whether the policy itself is codified in ordinance or identified in the jurisdiction's General Plan or both.

D. Voluntary or Mandatory

Only six percent of jurisdictions responding report voluntary programs, which allow more flexibility for developers but compromise local ability to guarantee affordable housing production. Los Alamitos and Long Beach both specifically blame the voluntary nature of their programs for stagnant production despite a market-rate boom. In general, our research indicates that the voluntary programs do not cause market-rate developers to build or facilitate affordable units unless including affordable housing makes an application more competitive in the permit approval process.

E. Inclusionary Requirement and Project Size

Variation from jurisdiction to jurisdiction in the percentage of units required to be affordable is significant, ranging from four to 35 percent. The average requirement in rental developments is 13 percent, which is also the average requirement for ownership housing. The most commonly found inclusionary percentage is 10 percent. However, approximately half of all jurisdictions require at least 15 percent and one-quarter require 20 percent or more.

In many cases, the inclusionary percentage is only applied to projects over a certain size, commonly ranging from three to 10 units. As Figures 2 and 3 indicate, there is relatively little difference between the percentage requirements for rental versus ownership. For example, the City of San Anselmo reports that no inclusionary units have been built because the inclusionary requirement is only required of projects over 10 units and all developments in recent years fell below this threshold. In 20 percent of jurisdictions, the inclusionary requirement is applied to all developments, regardless of size. Typically, smaller projects are allowed to meet the inclusionary goals differently than larger projects (in 42 percent of jurisdictions), more often than not through the payment of in-lieu fees. Still others require different percentages based on project or parcel size, as is the case in the City of Davis, where rental developments of over 20 homes must provide 35 percent of the homes as affordable versus 25 percent for rental projects under 20 units.⁴

Figure 2: Percent Rental Required

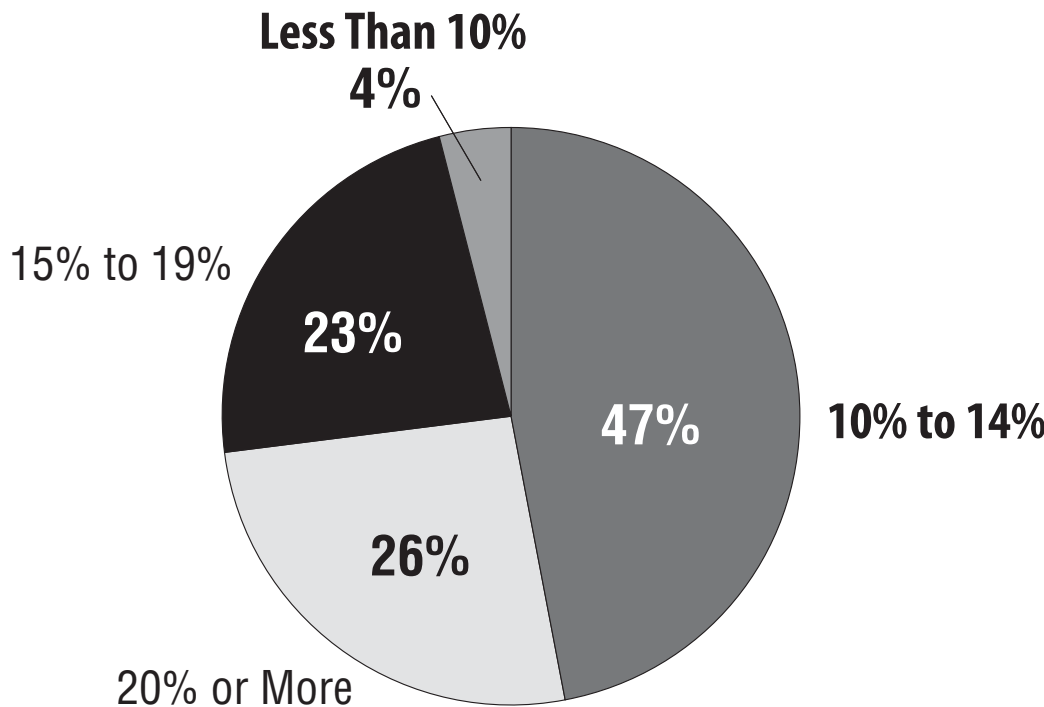
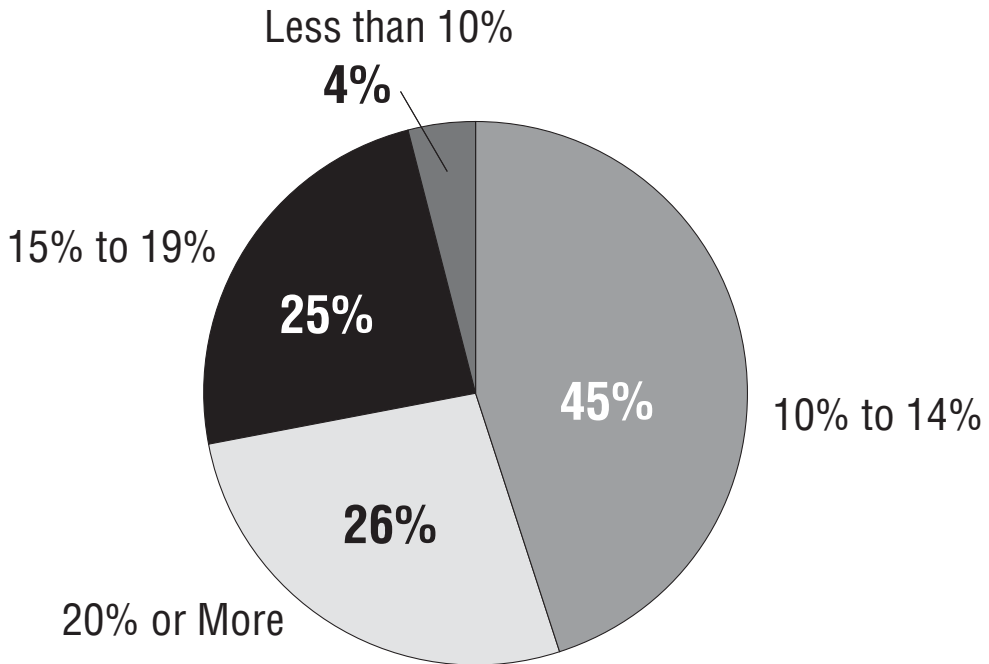


Figure 3: Percent Ownership Required



CASE STUDY

Morgan Hill

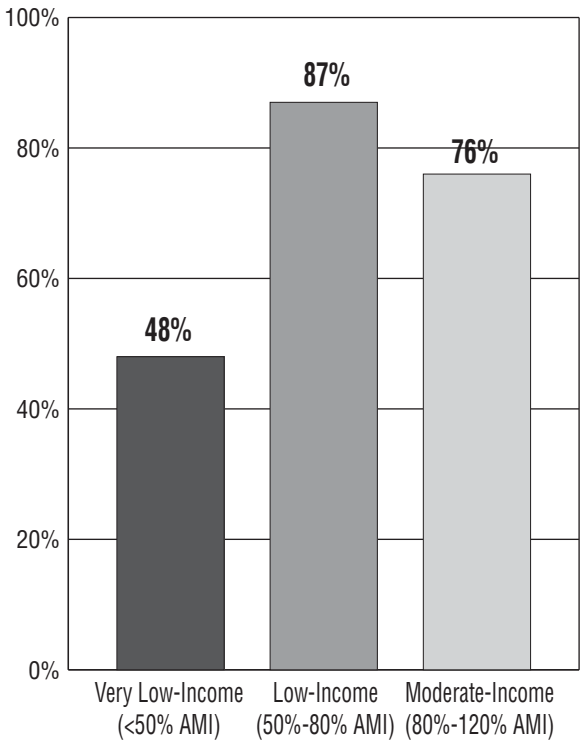
In general, jurisdictions with voluntary or incentive-only policies report that their policies did not produce the desired affordable housing. However, Morgan Hill in southern Santa Clara County is a notable exception. Morgan Hill accomplishes its inclusionary housing goals through its Residential Growth Management Policy, which limits the number of residential permits issued per year. The growth management policy is effectively a competition among potential projects. As part of the intense competition for permits, providing inclusionary affordable housing is worth as many as 13 points. In order to score high enough in the competition to get the permits for the overall development, builders must voluntarily choose from a set of inclusionary housing options. To date, the policy has created over 300 units of affordable housing.

F. Income Targeting

Most jurisdictions require that inclusionary homes be made affordable and offered to a predetermined income group, rather than providing developers with discretion or choices about whom to serve. Nonetheless, some jurisdictions do provide developers with options, such as providing a higher percentage of units to moderate-income households versus a lower percentage to very low-income households.⁵ For example, the City of Richmond in the San Francisco Bay Area offers developers the option of providing 10 percent of the units to very low-income households, 15 percent of the units to low-income households, or 17 percent of the units to moderate-income households.

As demonstrated by Figure 4, most programs target some percentage of their inclusionary homes to low- and moderate-income households, 87 percent and 76 percent, respectively. Fewer than half of the programs (48 percent) target very low-income households. In 59 percent of jurisdictions, no distinction is made between income targeting for rental units versus units for ownership. Of the other 41 percent of cases, the income targeting is linked to form of tenure. In these instances, rental units are often targeted to low-income households and for-sale units to moderate-income households.

Figure 4: Income Targeting



Many inclusionary policies have been adopted in order to address the requirements of California Housing Element law. For example, Calavita and Grimes found that all eight of the San Diego County jurisdictions with inclusionary programs had adopted inclusionary housing in order to compensate for past under-production in particular income categories.⁶ Because not all jurisdictions provided reliable data on the actual income limits of inclusionary units already produced, it is not possible to assess accurately who the actual beneficiaries of these policies are without more extensive and verifiable field research at the local community and project levels.

CALIFORNIA’S HOUSING ELEMENT LAW

In California, Housing Elements are state-mandated local plans for meeting housing needs, which are periodically required to be updated. The Housing Element is part of each locality’s General Plan, its constitution for growth. Every Housing Element must show that the jurisdiction has adequate land zoned appropriately to accommodate its projected housing need for all income levels.

G. Alternatives to Construction On-Site

The most common alternatives to on-site construction are in-lieu fees and land dedications. In addition, developers are sometimes allowed to build the affordable housing off-site or receive credit for excess affordable units built in previous projects through credit transfers.

The flexibility with which policies and programs regulate developers varies greatly from jurisdiction to jurisdiction. The table below shows that the majority of jurisdictions allow in-lieu fees or off-site construction, 81 percent and 67 percent, respectively. Often, these two alternatives are offered within the same program; in 55 jurisdictions (54 percent), both strategies are allowed.

COMMON ALTERNATIVES TO ON-SITE CONSTRUCTION

In-Lieu Fees	Developer can pay a fee into a local fund instead of constructing the required affordable units. Often, fees are calculated per unit or per square foot for each unit not built.	Allowed by 81% of surveyed jurisdictions (N=102)
Land Dedications	Developer can substitute a gift of land that may accommodate an equivalent number of units in place of affordable unit construction.	Allowed by 43% of surveyed jurisdictions (N=93)
Credit Transfers	Developer can credit affordable units built beyond the inclusionary requirement in one project to satisfy the requirement in another.	Allowed by 20% of surveyed jurisdictions (N=93)
Off-Site Construction	Developer can build the affordable units at a different site than the market-rate units, sometimes conditioned on agreeing to increase the number of affordable units to be built.	Allowed by 67% of surveyed jurisdictions (N=96)

Interestingly, cities that allow the use of alternatives under specific conditions have been more successful than cities without those conditions. Monterey County’s success is likely due to the use of: (1) restrictions on the use of the in-lieu fee option and (2) incentives for developers to construct more than the required number of affordable units (see Case Study, p. 20). In-lieu fees are only permitted under exceptional circumstances and are used specifically to buy land for affordable housing.

CASE STUDY
Carlsbad—The Benefits of Flexibility

A city of nearly 88,000 inhabitants in San Diego County, Carlsbad initiated its inclusionary program in 1993 during a period of fast residential growth. Impetus for the program came from a need to satisfy Housing Element requirements; before this time little affordable housing was produced. Despite effectively increasing the supply of affordable housing, the city still struggles to design adequate mechanisms to ensure continued affordability.

The ordinance requires 15 percent of all new residential development to be affordable to low-income residents, with an in-lieu fee option for projects of less than six units; larger developments are required to build. Land dedications are not regularly used, yet when the city joined a deal to finance a large affordable complex, some unassigned affordable units planned for construction were bought by small developers to satisfy their inclusionary requirements from other projects. Carlsbad’s Housing and Redevelopment Agency, emphasizes the importance of (1) requiring construction instead of allowing in-lieu fees indiscriminately, (2) setting in-lieu fees high enough to encourage construction and fund development elsewhere and (3) mandating concurrent construction to reduce social resistance.

In-Lieu Fees

In-lieu fees are among the most controversial elements of inclusionary housing. While most jurisdictions offer in-lieu fees as a potential option, there is relatively little standardization in terms of calculating in-lieu fees or determining at whose discretion the in-lieu fee is an option. In-lieu fees can significantly affect levels of affordable construction, not only because they allow developers to pay instead of build, but also because the methods of calculation and uses of in-lieu fees can render them relatively ineffective. On the other hand, in-lieu fees can provide jurisdictions with the funds to subsidize affordable housing that serves people of even lower incomes or create supportive housing for people with special needs, such as mental health or substance abuse problems. In addition, in-lieu fees can be used in conjunction with other housing funds, such as the federal and state Low Income Housing Tax Credit or the State of California's Multi-Family Housing Program.

Jurisdictions vary greatly in terms of how they calculate in-lieu fees, often based on either construction costs or potential revenue. Typically, the dollar total of fees collected is not sufficient to produce the same number of units that would have been produced had developers opted to build the units themselves. For example, in fast-growing Patterson in San Joaquin County, the in-lieu fee per affordable unit required is a mere \$7,340. Despite a 10 percent inclusionary requirement and growth of 750 units since the policy was enacted, the jurisdiction reports that its inclusionary program has created only five units of affordable housing since implementation. The County of Santa Cruz, on the other hand, has a \$272,889 fee per affordable unit. A more typical case is Livermore in Alameda County, whose fee in 2002 was \$122,720 per affordable unit—below what is actually needed to create the unit, but significantly increased from its previous level.

When in-lieu fees have been set below the level needed to actually fund new construction, they can undermine the program goals, as it is in the developer's clear financial interest to simply pay the fee. Therefore, a jurisdiction with a 20 percent inclusionary requirement but a low in-lieu fee might effectively create less affordable housing than a jurisdiction with a 10 percent requirement and fewer or less appealing alternatives to construction. To ensure that policies or ordinances produce results in keeping with their goals, the required fee should be high enough either to dissuade developers from opting out of construction or enable the city to finance construction of an equivalent number of affordable units elsewhere.

Some cities use in-lieu fees not for new construction, but for homeownership downpayment assistance or rental assistance programs, such as in the City of Coronado in southern California. While consumer subsidies are needed forms of housing assistance, they only indirectly affect production by increasing effective demand and do not ensure that supplies of affordable housing will increase.

In many cases, respondents credit a low in-lieu fee option with reducing the effectiveness of inclusionary mandates. According to the survey data, 80 percent of jurisdictions that reported numbers for affordable housing production allow in-lieu fees to be paid. Production numbers in these jurisdictions ranged from zero to levels commensurate with the outcomes anticipated by their policy goals. In other words, the in-lieu fee option may offer a way out for some developers who are not willing or able to construct affordable units themselves, but it does not necessarily impede affordable housing production in every case.

The freedom with which developers can choose fee payment also depends on policy design. In Davis, developers of smaller projects are allowed the in-lieu fee option only under circumstances of “unique hardship” as defined by the City Council. Many other jurisdictions allow the in-lieu fee option more freely, sometimes allowing developers to choose fee payment in all instances, or all developments below a certain size. In the case where an inclusionary formula obligates a developer to produce a fraction of an affordable unit, some jurisdictions require payment of in-lieu fees, instead of waiving the obligation entirely (see Case Study: Monterey County). Those jurisdictions that successfully produce affordable housing while using the in-lieu fee offer clues for effective policy design. The County of Monterey and Port Hueneme require that developers request permission to pay the in-lieu fee; projects are only allowed to use the in-lieu fee under certain circumstances defined on a case-by-case basis. This strategy avoids the overuse of the in-lieu fee alternative.

CASE STUDY

Making Every Unit Count in Monterey County — The Importance of In-Lieu Fees

In-lieu fees currently feed the engine driving Monterey County’s inclusionary housing production. Since 1980, developers have constructed 448 units to directly satisfy inclusionary requirements, while 940 units have been created with assistance from in-lieu fees and other funds. In-lieu fees are an option for developers of small projects (seven units or less) and are based on the replacement cost of an affordable unit and the financing gap between affordable and market housing costs. For example, a project in the coastal zone of the County would pay an in-lieu fee of \$339,636 per affordable unit required, which represents the difference between the average total development cost of \$546,000 and the affordable sales price for a family of four at 100 percent of area median income, which is currently \$206,364.

While other jurisdictions often waive requirements entirely in small projects, unincorporated Monterey County has greatly benefited from the in-lieu fees collected on each of these small projects, using funds for new construction and acquisition/rehabilitation projects. County planners note that, in the absence of an inclusionary policy, high land costs would prevent construction of affordable units. Monterey County requires permanent affordability for rental units, and imposes resale controls on homeowners who sell within 30 years. As of this writing, the County expects to amend its program by increasing inclusionary requirements to 20 percent (currently 15 percent), making the program mandatory for all developers, extending resale restrictions in perpetuity, eliminating the option for off-site construction, lowering the threshold for the in-lieu fee option to five units and crafting developer incentives.

Land Dedications

As noted above, 43 percent of jurisdictions responding allow land dedication instead of construction. This alternative faces similar challenges to in-lieu fees, in that the amount of land required to substitute for construction (similar to the amount of fees generated) must be large enough to ensure production of an equivalent number of units. Land dedications are most effective in areas where land is scarce and the cost is high; where the absence of land that is available for development and reasonably priced makes affordable housing development very difficult. In these environments, land dedications are most likely to yield significant resources for housing development.

A prerequisite for successful land dedication is that affordable units will be built on the dedicated land. Local governments must assume responsibility for this construction and often recruit nonprofit developers to complete the task. Typically, the land is deeded to the jurisdiction, which then deeds it to a community-based nonprofit on a competitive basis, or is deeded directly by the developer to a nonprofit organization. Edgewater Place in Larkspur in Marin County, for example, is a 50-unit development built by the Ecumenical Association for Housing on land dedicated by an adjacent condo developer. In this case, the land dedication allowed for double the number of units required under the policy by combining the land with funding from other sources.

Ensuring construction on dedicated land can be problematic. Portola Valley in the San Francisco Bay Area, for example, reports that the land dedication option may be revoked because the local government has been unable to advance development on four lots previously dedicated to it. Ideally, the land to be dedicated should be integrated into, or contiguous to, the proposed market-rate development. The construction of affordable units on isolated plots of land may undermine the economic and social integration that many inclusionary policies aim to create.

Ultimately, the success of land dedications depends on the quality of the land being dedicated: its size, shape and location; the existence of adequate sewer and water capacity and other infrastructure; environmental limitations; the capacity of local developers, especially nonprofit organizations, to undertake the development; the availability of financing to improve the land and build and operate the housing; and the level of public acceptance by the surrounding community.

Off-Site Construction

The allowance that affordable units may be built off-site also challenges the inclusive goals of inclusionary policy. Debate arises over whether programs should permit off-site development if that is the best way to maximize the number of affordable units that can be developed or, conversely, whether it is more important to insist on integrated development on-site even if such development yields fewer units.

As noted above, the location of affordable units on an isolated site restricts the extent to which new development can promote residential integration. In some cases, programs require that developers building off-site include more than the inclusionary allotment of affordable housing. This strategy attempts to justify the isolated construction by ensuring a greater number of affordable units, arguably the highest priority of inclusionary policy overall.

Off-site construction issues are particularly relevant when considering partnerships between for profit and nonprofit developers. In some cases, developers team up to satisfy

the inclusionary requirements; the for profit developer builds the market-rate units and the nonprofit builds the affordable units off-site on land it controls with funding support provided by the former. While this strategy allows each developer to exercise its expertise and appears to be a win-win proposition for all parties, the segregating effects should not be overlooked. In contrast to the land dedication option, however, where jurisdictions can be left with no means to develop the dedicated land, off-site construction requires the developer to be responsible for actual development.

CASE STUDY

Choosing Production Over Integration in Livermore

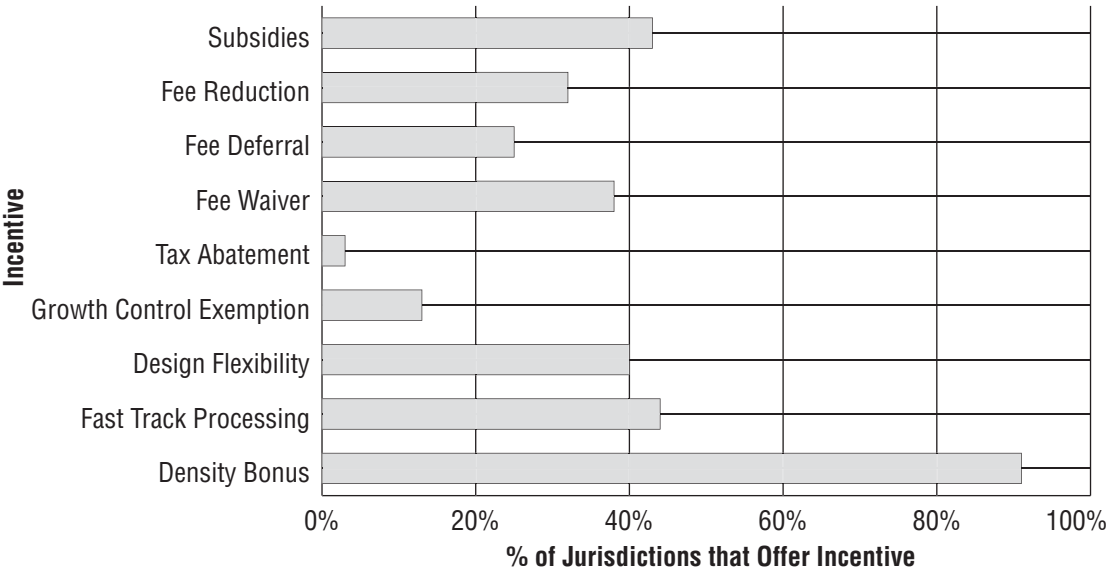
Livermore’s inclusionary program is dedicated to boosting the affordable housing stock as the top priority, with secondary concern for integration. The program was first implemented in 1986 and has since become an integral part of the permit approval process. With a Residential Growth Management Policy as part of the General Plan, Livermore restricts residential development through a competitive permit selection process. Inclusionary requirements must be met as part of this review and project proposals that provide 35 to 50 percent affordable may bypass the selection process completely.

By discretion of the City Council, off-site construction, in-lieu fee payment or land dedications are considered and the City claims to be flexible wherever affordable construction can be maximized. Accordingly, Livermore reports that in-lieu fees have helped create some 600 affordable units. The City calculates the in-lieu fee as 10 percent of the difference between the cost of developing the market-rate unit and the maximum affordable purchase price for a unit of that size. As of 2002, that calculation resulted in a fee of over \$120,000 per affordable unit. Fee collections finance Affordable Housing Fee Fund activities, including mortgage and rental subsidies, new construction and rehabilitation.

H. Developer Incentives

Various incentives are offered to developers to promote the construction of affordable housing. These incentives can be critical. Some jurisdictions stimulate significant numbers of affordable units by granting development benefits for those projects that either fulfill or exceed the inclusionary percentage. Some jurisdictions credit incentives for the success of their inclusionary program, claiming they have directly contributed to increases in actual affordable production (see Figure 5).

Figure 5: Developer Incentives



Density bonuses are by far the most popular incentive offered to developers to build affordable housing, reported by 91 percent of the respondents. There is some question, however, whether this density bonus can be used in some jurisdictions due to parking, setback and other requirements that effectively negate efforts to increase density. In some cases, developers may opt to build at less than the maximum allowable density in order to maximize the amount of nonresidential space for project facilities and open areas and minimize the density concerns of neighbors.

California’s Density Bonus Law

Technically speaking, all jurisdictions in California are required to offer a density bonus per state law. Government Code Section 65915 provides that a local government shall grant a density bonus of at least 25 percent and an additional incentive or financially equivalent incentive(s), to a developer of a housing development agreeing to construct at least: a) 20 percent of the units for low-income households; or b) 10 percent of the units for very low-income households; or c) 50 percent of the units for senior citizens. Other incentives might include reduced parking requirements, reduced setbacks, fee waivers or other concessions identified by the developer or jurisdiction.

Design flexibility often means requiring identical or similar exteriors but allowing variations in internal features in order to facilitate financial feasibility for developers. While design differences between market- and below market-rate units might ease the burden for developers, jurisdictions struggle to avoid the neighborhood opposition and social stigma that can come with housing that stands out because of external design standards that are compromised or lowered to reduce costs.

The City of Livermore in Alameda County takes these issues into account by requiring “comparability of units” in its inclusionary program. This is defined in terms that reflect the goals of integration common in many communities: “From the street, the reserved units must not be distinguishable from other units in the project.” Nonetheless, Livermore does allow for design flexibility in the interiors, focusing its attention on numbers of bedrooms and bathrooms and amenities such as air conditioning and laundry facilities.

The relatively high percentages of respondents providing subsidies, as well as various fee concessions as incentives, indicates that many jurisdictions are “paying” for inclusionary housing, either by direct cash assistance, foregone revenue or both. In other words, developers in these communities are not bearing 100 percent of the cost of earmarking a percentage of their units for affordable housing. Some jurisdictions release developers from the obligation to produce the affordable units when adequate subsidy is not available. Unlike direct housing subsidies, it is not clear whether fee concessions actually secure a specific public benefit, such as long-term affordability. Because the depth of subsidy was only reported by a few jurisdictions, future research in this area would be helpful.

CASE STUDY

Subsidizing Inclusionary Housing

Roseville, a rapidly growing suburb of Sacramento, adopted a General Plan policy in 1988 mandating housing affordability. Each plan area is required to meet a 10 percent inclusionary requirement, but the specific plan mandates different percentages on different parcels within each area. When City funding is not available to assist construction of below market-rate units, the requirement is waived entirely. The program has produced over 2,000 units of very low-, low-, and moderate-income housing since adoption of the policy. As required, 75 percent of affordable units constructed have been rental units.

I. Length of Affordability

Ensuring that new affordable units stay affordable is another problematic issue. Some jurisdictions report the loss of affordable housing stock because there were not adequate requirements or monitoring mechanisms in place to guarantee continued affordability. Affordable rents can easily be recalculated for subsequent renters and are typically offered by nonprofit and for profit ownership entities subject to long-term use agreements or deed restrictions that are conditions of the underlying financing. Restricting homeowners from reselling affordable units at market-rate prices or requiring equity sharing are much more difficult to regulate and require sustained and active monitoring by local officials.

One stunning example of the consequences of such policy failures is the City of Irvine in Orange County. Because the city had no system for resale control prior to 2001, almost all of the 1,610 ownership units created before that time are no longer part of the affordable housing stock, having now been resold at market-rate prices.⁷ In contrast, the City of Palo Alto in the heart of Silicon Valley has a 59-year deed restriction on its inclusionary ownership units, which is reset each time a home is sold or refinanced, achieving something very close to permanent affordability. Palo Alto also retains the right to purchase the home upon resale and only assigns this right to a buyer from its waiting list.

While there is general agreement on the value and the mechanisms for ensuring long-term affordability of rental housing, for-sale housing is a more complicated picture. On the one hand is the desire to enable low- and moderate-income homebuyers to accumulate equity (wealth), which is one of the main benefits of homeownership in this country. On the other hand is the desire to ensure that public policy and investment assists more than just the one household that initially buys an affordable home.

Virtually all jurisdictions now report that they have formal mechanisms to maintain affordability over time. Deed restrictions, resale controls and rental contracts are the most common means by which affordability is ensured. These restrictions range from periods of 10 years to perpetuity with the median length for rental housing 42 years and for-sale housing 34 years. Permanent affordability is reported in 20 percent of programs for both rental and for-sale.

Over the last decade, a significant number of jurisdictions have chosen to amend their policies or ordinances to address deficiencies in affordability controls. In fact, nearly 50 percent of all jurisdictions have amended their ordinances at least once, many in the last five years. In doing so, jurisdictions have increased the term of affordability to 55 years or permanent affordability. Many have adopted new policies or mechanisms to address the particular challenge of monitoring and maintaining the affordability of for-sale units.

Nonetheless, monitoring units remains an area of obvious concern. Many jurisdictions declined to answer survey questions related to monitoring and overall tracking of inclusionary production. Among those that responded, most cities and counties report that they assume overall responsibility for monitoring long-term affordability, but it is unclear from discussions with local staff just how effectively those units are monitored. The high incidence of incomplete responses on monitoring leads the researchers to believe that greater emphasis in this area is needed.

J. Obstacles to Implementation

Local officials cite a number of factors that complicate or undercut successful implementation of inclusionary programs. The principal obstacle is scarcity of land for development, noted by 59 percent of jurisdictions, followed by developer opposition, noted by 39 percent. Lack of funding and community opposition are obstacles in 31 percent and 19 percent of jurisdictions, respectively. Other respondents cite high land prices and inadequate public works infrastructure as challenges to the development of new affordable housing.

Developer opposition arises from the perspective that inclusion of affordable housing in market-rate developments is financially prohibitive and/or unfairly shifts costs to moderate- and above moderate-income families via higher sales prices and rents. Moreover, profit motivated builders argue that they are unfairly forced to shoulder the financial onus for an affordable housing provision that should rightly be borne by the public sector in partnership with below market-rate developers in the business of developing and operating affordable housing.

In the face of enormous housing needs, expectations are shifting in the contemporary development scene. Accepting the task of building or supporting affordable housing will require for profit developers to adapt. While it is not surprising that there is resistance, the market arguments that inclusionary policies will stifle construction or dramatically increase market-rate real estate prices have yet gone unproved. During the 1990s, construction rates and permit valuations remained steady or rose in inclusionary jurisdictions, as they did statewide. Anecdotal reports confirm that developers continue to build and that more newly constructed units are affordable as the result of local inclusionary programs.

Conclusion

The rapid expansion of inclusionary housing in California over the last 30 years has aroused considerable debate. Advocates on both sides of the issue have raised questions about the impact of various kinds of inclusionary policies. In this section, we attempt to answer some of the critical questions pertaining to inclusionary implementation and make policy recommendations based on the experience of the 15 most successful programs as measured by sustained and significant production of affordable housing.

Although the data collected from the survey do not provide definitive answers, it is instructive to compare the 15 programs regularly producing affordable housing with the other 92 programs in the state, some of which have struggled to achieve consistent production.⁸ We recognize that no simple statistical comparison can measure a program's success without understanding the particular local contexts involved. Likewise, it may very well be that the local variability of inclusionary programs is a key to their success.

A. Critical Questions in Inclusionary Implementation

Does a strong inclusionary policy discourage overall housing production?

Perhaps not surprisingly, it appears that the jurisdictions producing the most inclusionary units are those that have experienced rapid expansion. To be specific, the top-producing jurisdictions grew at an average rate of 25 percent compared to 14 percent in the other inclusionary jurisdictions from 1990 to 2000. These jurisdictions have managed to harness their exceptionally rapid population growth to stimulate affordable housing production. Respondents who offered comments on the subject believe their policy has not hindered overall housing production.

One of the key measurements of a policy's strength is the percentage of units required to be affordable. Interestingly, the more productive programs had similar percentage requirements to those of the other programs. This would seem to indicate that the results of a program depend heavily on other factors. One respondent commented that his jurisdiction had to reduce inclusionary requirements from 25 percent to 20 percent of all units produced to make the program effective, while four respondents recommended raising the percentage of units currently required to make their programs more effective.

PERCENTAGE OF NEW UNITS REQUIRED TO BE AFFORDABLE				
% REQUIREMENT	15 MOST PRODUCTIVE PROGRAMS		OTHER PROGRAMS	
	RENTAL	OWNERSHIP	RENTAL	OWNERSHIP
Less than 10%	7%	13%	4%	3%
10-14%	40%	33%	45%	43%
15-19%	33%	27%	23%	21%
20% or more	20%	20%	22%	22%

In contrast, comparison shows that deep income targeting is a feature of many policies that produce a significant number of units. In fact, the most productive programs are more likely to target low- and very low-income households and less likely to target moderate-income households. On the surface, this would seem counterintuitive; programs with relaxed or higher targeting would seem more likely to produce greater numbers of units than programs with more stringent targeting. What this analysis suggests is that deeper targeting does not, in and of itself, discourage production and, perhaps, coupled with staff commitment, funding resources and other local factors can create an environment for success.

INCOME GROUPS TARGETED BY INCLUSIONARY PROGRAMS		
INCOME-TARGETING	15 MOST PRODUCTIVE PROGRAMS	OTHER PROGRAMS
Very Low-Income	60%	42%
Low-Income	87%	71%
Median-Income	53%	65%

Can a voluntary program be as effective as a mandatory program?

Only six jurisdictions responding to the survey identified their policy as voluntary. None of these jurisdictions was among the most productive and three reported no production of inclusionary units at all. Programs classified as “mandatory with exceptions” because they allow developers to avoid inclusionary requirements under certain conditions, such as small project size or lack of funding, appeared in both groups. Although truly voluntary programs are generally unsuccessful in producing affordable units, mandatory programs with exceptions are not necessarily less effective simply because they permit exceptions.

Do alternatives to construction promote the production of affordable housing or merely provide a loophole for developers who want to avoid inclusionary requirements?

The highly productive programs are more likely to permit most alternatives to construction than other programs. In-lieu fees are permitted by a high percentage of all programs, although somewhat less often by the most successful programs. The success or failure of an in-lieu fee option is likely to depend on the way the fee is calculated, as well as the ways in which collected funds are used. This correlation suggests that flexibility is not inimical to program success, provided it is accompanied by appropriate controls to ensure that units are still produced.

ALTERNATIVES TO CONSTRUCTION ALLOWED BY INCLUSIONARY PROGRAMS

ALTERNATIVES TO CONSTRUCTION	15 MOST PRODUCTIVE PROGRAMS	OTHER PROGRAMS
Off-Site Allowance	86%	64%
Land Dedication Allowance	60%	39%
In-Lieu Fees	73%	80%
Developer Credit Transfer	33%	17%

Should jurisdictions allow owners to “opt out” of inclusionary requirements altogether, based on small project size or infeasibility?

Of the most productive programs, none allow exemptions to inclusionary requirements based on infeasibility. The most productive programs are also slightly less likely than other programs to allow exemptions based on small project size.

EXEMPTIONS PERMITTED BY INCLUSIONARY PROGRAMS

EXEMPTIONS	15 MOST PRODUCTIVE PROGRAMS	OTHER PROGRAMS
Small project size	67%	82%
Infeasibility	0%	15%

What incentives help developers produce affordable units?

The most productive programs were much more likely than the other programs to subsidize the construction of affordable units (71 percent versus 38 percent). The substantial difference suggests that funding is an important facet of a successful inclusionary program. There was little difference between productive programs and less productive programs with respect to other incentives offered.

What prevents inclusionary programs from being successful?

Respondents identified a number of obstacles to the production of inclusionary units. Among the most productive programs, lack of funding was the most commonly cited concern, listed by 67 percent of these respondents compared to only 24 percent of the others. On the other hand, scarcity of land was much more likely to be identified as an obstacle by the less productive programs (64 percent versus 33 percent). Respondents from both groups frequently mentioned developer opposition as a significant obstacle to construction of affordable units.

Several considerations help explain why jurisdictions producing more units perceive the obstacles to inclusionary production differently. Since land is a prerequisite for all new construction, jurisdictions with a limited supply of land are much more likely to find themselves producing fewer units each year than other jurisdictions. In other words, programs producing fewer units may be more restricted in terms of their available land. The more productive jurisdictions’ greater concern about funding is probably due to a couple of factors. One is that these jurisdictions were also more likely to report that subsidies were provided for inclusionary units, implying that limited funding would truly harm these programs’ ability to produce. Also, jurisdictions might be less likely to single out limited funding as a problem when other barriers frequently prevent a project from moving to the funding stage.

Although many respondents in both groups identified developer opposition as an obstacle, one respondent commented that most developers in California are “resigned” to inclusionary policies, given the number of jurisdictions in the state that have such requirements. Another respondent observed that market-rate housing developers may not like inclusionary programs, but choose to produce affordable units rather than stop developing altogether.

OBSTACLES TO SUCCESS OF INCLUSIONARY PROGRAMS		
OBSTACLES TO IMPLEMENTING POLICY	15 MOST PRODUCTIVE PROGRAMS	OTHER PROGRAMS
Community opposition	8%	22%
Developer opposition	42%	38%
Local government processes	0%	5%
Lack of funding	67%	24%
Scarcity of land	33%	64%
Other	33%	27%

What other factors tend to increase the number of units produced?

The most productive programs were adopted earlier, but amended more recently, than the others. It is not surprising that the jurisdictions that have had a sustained commitment and continued to fine tune and update their programs, would be the ones that have achieved the most production of affordable units.

B. Policy Recommendations for Local Governments

There is a great deal of variation in the success of local inclusionary programs, as judged from the production of affordable units. The following policy recommendations for local governments are drawn largely from the characteristics of those programs that have produced the most affordable units since their inception. Since the most productive programs are often older, the recommendations below also include successful elements

of newer programs, as well as program elements contained in recently updated inclusionary policies. While each jurisdiction has unique circumstances and needs, cities and counties developing a new inclusionary program (or revising an existing program) can learn from what is working well elsewhere.

Inclusionary Percentage

Aim high in the percentage of units required to be affordable; 15 percent is realistic in most communities. Design incentives and program flexibility can mitigate the burden developers face in meeting inclusionary requirements, as described below.

Income Targeting

Unless financially infeasible, require housing for very low-income, low-income, and moderate-income households to be included. Section 8 vouchers can provide deeper affordability. Income categories can and should be adjusted based on local needs; for example, programs can target moderate-income units to a maximum of 100 percent of median, instead of 120 percent. The relative need of income groups as identified in the locality's Housing Element should guide inclusionary program design, with the inclusionary housing complementing other housing programs, such as new construction of assisted housing.

Rental and Ownership

Adopt inclusionary requirements for rental and for-sale housing that are similar enough so that developers continue to provide an appropriate mix of both housing types. Creating too great a difference between the targeting of inclusionary rental units versus for-sale units could create an unintended financial incentive for developers to produce only for-sale housing.

Alternatives to Construction On-Site

Offer some flexibility, such as in-lieu fees, land dedication or off-site development, but subject to local government determination that the alternative meets the need for affordable housing at least as well as traditional on-site inclusionary units.

Where in-lieu fees are an option, set the fee level as high as the cost to the locality of making the units affordable without other public subsidy. In other words, a decision to build units or pay fees should be revenue neutral, and the locality collecting the fees should be able to fund as many units as would have been required. In-lieu fee levels should be tied to the cost of construction and adjusted regularly. Allow in-lieu fees at the discretion of local government or in specific circumstances, such as when fractional units are required, or when a developer can prove that providing affordable units on-site is financially infeasible.

Developer Incentives

Provide incentives that local developers want and can use. Consult with developers during program design to find out how to structure density bonuses, reduced parking requirements, expedited permit review, design differences, growth control exemptions, etc., so that they are meaningful incentives.

Length of Affordability

Require units to be kept affordable permanently or for at least 55 years for rental homes. For homeownership units, programs should allow for reasonable amounts of equity to accrue to owners while still ensuring the long-term affordability of the home. Design effective mechanisms to track long-term affordability, such as restrictions recorded against the property.

Endnotes

¹Various jurisdictions listed on the California Planners Information Network (www.calpin.ca.gov) self-report having some kind of inclusionary housing. Our research confirmed that many of these jurisdictions only have formal inclusionary programs as required or governed by State Redevelopment Law or the Coastal Act.

²Jurisdictions enforcing inclusionary requirements as part of Redevelopment Agency practices or State Density Bonus Law, but with no local policy, were not included.

³It seems likely that more jurisdictions with inclusionary ordinances also have policies in their General Plans since local laws are required to be consistent with General Plans.

⁴For the purposes of the charts comparing inclusionary practices in California, the authors have classified those policies in terms of the minimum percentage required for a project.

⁵Figure 4 provides detail on those variations, but for the income targeting charts in this section, the authors have classified multiple choice policies in terms of the highest income target allowed at the developer's discretion.

⁶Calavita and Grimes, p. 160-5.

⁷Calavita and Grimes, p. 155.

⁸Several factors determine the relative “strength” of an inclusionary policy. A multivariate statistical analysis to correlate overall housing production with the relative strength of a locality's inclusionary program, controlling for other factors, would not be possible based on the data collected. However, we have made simple correlations that may explain, at least in part, the success experienced by the top 15 programs in terms of annual production relative to the other 92 programs, and dispel some of the negatives associated with different inclusionary program features. These jurisdictions produce at least 35 affordable units per year.

Avoiding Constitutional Challenges to Inclusionary Zoning

By Deborah Collins and Michael Rawson

Given the vibrant legal debate on property rights issues nationally, it should come as no surprise that inclusionary housing is a highly controversial topic. This article addresses attacks based on the United States Constitution.¹ Constitutional attacks on local land use actions generally allege violation of one or more of three provisions: 1) the Fifth Amendment prohibition against taking without just compensation; 2) the substantive and procedural protections of the due process clauses of the Fourteenth Amendment; and 3) the equal protection clauses of the Fourteenth Amendment. A recent California decision upheld the constitutionality of the City of Napa's inclusionary zoning ordinance and provides significant guidance on all of these issues.²

Stepping back, the authority for local governments to adopt zoning and land use regulations such as inclusionary zoning stems from their "police power." This power emanates from the Tenth Amendment to the United States Constitution, and entitles communities to adopt laws protecting the public's health, safety and welfare, including the broad discretion to determine the use and development of a finite supply of land within their borders.³ Any controls or regulations that are not unreasonable and bear some relationship to the general welfare of the community are permissible unless proscribed by preemptive state or federal laws or by the federal or state constitution. This article addresses attacks based on the United States Constitution.⁴

Based on its findings related to the critical need for affordable housing and a diminishing supply of land to accommodate those needs, the Napa inclusionary zoning ordinance requires developers to set aside ten percent of all new residential units as affordable housing. Developers have the opportunity to provide "equivalent alternatives," including land dedication, off-site construction or in-lieu payments. The ordinance also provides several concessions and incentives to developers in exchange for the inclusionary requirement, including expedited processing, waiver of development standards, loans and grants, and density bonuses. The ordinance also provides an opportunity for developers to appeal for an adjustment or waiver of the inclusionary requirement "based on the absence of any reasonable relationship or nexus" between the development's impact and the inclusionary requirement.⁵

¹Readers are encouraged to also review the constitution, statutes and case law addressing land use regulation in their states.

²*Homebuilders of Northern California v. City of Napa*, 90 Cal.App. 4th 188 (2001), review denied 2001 Cal. LEXIS 6166 (2001) and cert. den. 535 U.S. 954 (2002).

³See *Euclid v. Amber Realty Company*, 272 U.S. 365, 387 (1926); *Agins v. City of Tiburon*, 447 U.S. 255, 260-63 (1980); and *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978).

⁴Readers are encouraged to also review the constitution, statutes, and case law addressing land use regulation in their states.

⁵See City of Napa, California Mun. Code 15.94.050 (1999), available at <http://www.cityofnapa.org/municipal-code>.

A. Takings Issues After *Napa*— A Sound Ordinance Is Not A Taking

The Fifth Amendment prohibits the taking of private property for public use without just compensation. The courts have established a two step analysis for determining whether a local regulation is a taking: 1) whether it substantially advances a legitimate state interest⁶ or 2) whether it denies the property owner all economically viable use of the property.⁷ Generally, in applying this analysis to local land use regulations, the courts will give great deference to the local government's decision, recognizing that the community adopts these regulations under the broad authority of the police power.⁸

1. Inclusionary Requirements Substantially Advance Legitimate State Interests

The *Homebuilders of Northern California v. City of Napa* court had no doubt that the City had a *legitimate interest* in requiring the provision of affordable housing. The “assistance of moderate-income households with their housing needs is recognized in this state as a legitimate governmental purpose.”⁹ The court also referred to state legislation mandating that development of sufficient housing for all Californians is a matter of statewide concern and that local governments have “a responsibility to use powers vested in them to facilitate improvement and development of housing to make adequate provision for the housing needs of *all economic segments of the community*.”¹⁰

The *Napa* court also found it “beyond question” that the City’s inclusionary ordinance will *substantially advance* these important affordable housing interests. When determining whether a land use requirement, condition or fee substantially advances a legitimate state interest, a court is essentially deciding whether there is a “nexus” between the interest advanced and the requirement (*i.e.*, whether there is a sufficient relationship between the two). Generally, a court will defer to the local government’s assessment of that relationship and will not second guess the locality. Recently, however, the United States and California Supreme Courts have applied a “heightened scrutiny” test when reviewing *land dedication requirements or exaction fees* imposed on an *ad hoc* basis as a condition for approval of particular

⁶Due process focuses on whether the government regulation is *related to* the government interest, while the takings analysis is slightly stricter—whether the regulation *substantially advances* the interest. See *Erblich v. City of Culver City*, 12 Cal. 4th 854, and fn 7 (1996).

⁷*Agins v. City of Tiburon*, 447 U.S. 255 (1980).

⁸See *Euclid* at 387; *Penn Central Transp. Co. v. New York City*, 438 U.S. 104, 124; *Village of Belle Terre v. Boraas*, 416 U.S. 1, 4-6 (1974).

⁹*Homebuilders v. Napa*, 90 Cal.App. 4th 188 at 195, quoting *Santa Monica Beach, Ltd. v. Superior Court*, 19 Cal.4th 952, 970.

¹⁰*Id.*, quoting Cal. Govt. Code §65580(d). Mandating the inclusion of affordable housing also can help counteract the effect of past exclusionary zoning practices and further the goals of state and federal fair housing laws. See Roisman, *Opening the Suburbs to Racial Integration: Lessons for the 21st Century*, 23 W. New Eng. L. Rev. 65.

developments.¹¹ The *Napa* court found that the “heightened scrutiny” test did *not* apply to its review of Napa’s inclusionary zoning ordinance because it was a broad-based ordinance rather than an ad hoc response (*Napa* at 196).

A local ordinance or regulation that, on its face, substantially advances a legitimate state interest—as does the *Napa* ordinance—can nonetheless violate the takings clause if it is *applied* to a particular development in a way that fails to advance the interest. In other words, if the regulation does not include clear implementation standards and procedures, an inclusionary requirement could conceivably be applied in an arbitrary or discriminatory manner to a particular development and consequently be found to lack the essential nexus to the interest.

Napa involved a challenge to the City’s ordinance, only “on its face” (not “as applied” to a particular development). However, the court’s reasoning provides clear guidance on how an inclusionary zoning ordinance also can survive a taking challenge to a particular development.¹² In *Napa*, the inclusionary ordinance provides significant benefits to the developer—expedited processing, fee deferrals, loans or grants and density bonuses—which balance the regulatory burden. “More critically, the ordinance permits a developer to appeal for a reduction, adjustment or *complete waiver* of the ordinance’s requirements. Since the City has the ability to waive the requirements imposed by the ordinance, the ordinance cannot and does not, on its face, result in a taking.”¹³

Thus, to ensure an inclusionary ordinance can avoid unconstitutional *application*, the ordinance should provide standards and procedures for reducing, waiving or mitigating the requirements. Clearly, what was most important to the *Napa* court was the possibility of complete waiver of the requirements. However, the court also emphasized that an ordinance that provides significant benefits to developers may offset the impact of the inclusionary obligations. Accordingly, the appeals process provided in an ordinance should first require a developer to show that the benefits afforded by the ordinance do not fully compensate for the alleged impermissible hardship, before making reductions, alternative compliance or waiver available.

¹¹In *Nollan v. California Coastal Commission*, 483 U.S. 825 (1987), the U. S. Supreme Court held that there must be an “essential nexus” between an ad hoc dedication imposed as a condition of development and the impacts of the development. *Id.* at 837. Then, in *Dolan v. City of Tigard*, 512 U.S. 374 (1994) the Court found that the degree of the nexus between the impact and the dedication must be one of “rough proportionality” as assessed by an “individualized determination” with some “quantification.” *Id.* at 391. The California Supreme Court considered this “*Nollan/Dolan* heightened scrutiny test” in *Erblich v. City of Culver City*, 12 Cal.4th 854 (1996) and held that the test applies to fees as well as to dedications, *but only to those imposed “on an individual and discretionary basis.”* (Emphasis added.)

¹²“A claim that a regulation is invalid *on its face* is only tenable if the terms of the regulation will not permit those who administer it to avoid an unconstitutional *application* to the complaining parties.” 90 Cal.4th at 194 (Citations omitted).

¹³*Napa* at 194 (emphasis in original).

2. Inclusionary Requirements Do Not Deprive Owners of All Economically Viable Use of the Property

Another potential challenge to the application of an inclusionary zoning requirement is that the financial impact of the regulation on a particular development is so drastic that the effect should be deemed a taking. Inclusionary ordinances do not *preclude* development; they merely require a reasonable percentage of the development to be affordable. It is highly unlikely that an inclusionary requirement would have so substantial an impact as to deprive an owner of all economically viable use of the property. Moreover, even local regulations that have diminished property values by as much as 87.5 percent have been upheld by the courts.¹⁴ Accordingly, it is doubtful that an attack on this basis could succeed.

B. Substantive Due Process Issues After *Napa*—Availability of Appeal, Waiver and Alternatives Important

The Fourteenth Amendment's guarantee of due process of law has been interpreted to prevent governments from "enacting legislation that is 'arbitrary' or 'discriminatory' or lacks 'a reasonable relation to a proper legislative purpose.'"¹⁵ This is known as the "reasonable relationship test."

Opponents to inclusionary zoning argue that such laws fail the reasonable relationship test because they amount to price or rent controls that lack procedures to ensure that developers will receive a "fair return" on their investments.¹⁶

The first hurdle for a "fair return" argument to overcome is whether a due process analysis is even applicable to a land use regulation such as an inclusionary zoning ordinance. In *Armendariz v. Penman*,¹⁷ the Ninth Circuit recognized that "the use of substantive due process to extend constitutional protection to economic and property rights have been largely discredited," because the takings clause provides sufficient constitutional protection.¹⁸ Since the takings clause has been found to relate more directly to land use regulation than substantive due process,¹⁹ a substantive due process claim challenging an inclusionary zoning ordinance should be precluded.

Nevertheless, inclusionary requirements, including in the *Napa* case, have been attacked as price controls that violate the due process clause. The court in *Napa* stopped short of holding that the "fair return" standard did not apply in inclusionary zoning cases because it could find the *Napa* ordinance was valid on its face on other grounds. However, it indicated that it is unlikely that a developer is entitled to a "fair return" under the due process clause, noting that the "fair return" standard developed in evaluating restrictions placed on regulated industries such as railroads and public utilities.²⁰

¹⁴See, e.g., *Penn Central Transp. Co. v. New York City*, 438 U.S. 104 (1978) upholding a landmark historic preservation regulation and establishing a three-factor test for determining the financial impact of a regulation.

¹⁵*Kavanau v. Santa Monica Rent Control Bd.*, 16 Cal.4th 761, 771 (1997) (citing *Nebbia v. New York* (1934) 291 U.S. 502, 537).

¹⁶See discussion in *Home Builders Assn. v. City of Napa*, 90 Cal.App.4th 188 at 198.

¹⁷*Armendariz v. Penman*, 75 F.3d 1331, 1318-1319 (9th Cir. 1996).

¹⁸*Id.* at p. 1318-1319, 1324.

¹⁹See e.g. *Agins v. Tiburon* (1980) 447 U.S. 225.

²⁰*Napa* at 198.

Although it has since been used in assessing rent control ordinances, the *Napa* court doubted that it would apply to inclusionary zoning ordinances (*Id.*). The court further noted that although the ordinance may not have specifically given the administrative agency authority to make adjustments to guarantee a fair return, this ability was “present by implication” in light of the administrative appeal available under the ordinance.²¹

Thus, a constitutionally defensible inclusionary zoning ordinance should contain provisions which allow a developer to seek administrative relief and provide sufficient flexibility to provide that relief. When an ordinance contains provisions which allow for administrative relief, the court reviewing the ordinance must presume that the administrative body will exercise its authority in conformity with the Constitution.²²

Adequate administrative standards and procedures for relief also protect against application of inclusionary requirements in arbitrary or discriminatory ways to individual developers. Fair application of clear standards will lessen the likelihood that the requirement *as applied* to a particular developer will be found to be arbitrary or a denial of a fair return.

C. Equal Protection Issues—

A Sound Ordinance Will Avoid Problems

The equal protection clauses of the Constitution prohibit state and local governments from depriving persons of equal protection of the laws (U.S. Constitution, Fourteenth Amendment). On the surface, all land use and planning laws and practices would seem to violate this principle because their purpose is to treat property owners differently—permitting uses on some property and prohibiting them on other property. However, courts will generally uphold a local land use regulation as a lawful exercise of the police power if it bears a *rational relationship* to a legitimate governmental interest.²³ Consequently, an inclusionary requirement that satisfies the takings and due process mandates, will also pass muster under the equal protection strictures.

Inclusionary requirements are more likely to be challenged as unconstitutional under the takings clause or the substantive due process clause. Both of those relate more directly to the specific offenses usually raised by challengers—lack of sufficient nexus (takings) and arbitrary price control (due process). The plaintiffs in *Napa* attacked the constitutionality of the City’s ordinance on takings, substantive due process and other state law, not equal protection. Almost all successful equal protection challenges of land use actions have been when the local government *applies* local regulations to landowners in an unequal, discriminatory manner.²⁴ Therefore, if an inclusionary

²¹*Id.*, citing *City of Berkeley v. City of Berkeley Rent Stabilization Bd.* 27 Cal.App.4th 951, 962 (1994).

²²*Napa* 90 Cal.App.4th at p. 199 (citing *Fisher v. City of Berkeley*, 37 Cal.3d 644, 684 (1984)).

²³Like the test under the due process clause, the “rational relationship test” is virtually identical to that employed in substantive due process cases. It is also akin to the “furtherance of a legitimate government purpose” test for takings claims. If a land use regulation intentionally discriminates against a “suspect class” of persons (e.g. racial or ethnic minorities), however, or denies someone a “fundamental right” (e.g. the right to live as a family), it will be held to a much tougher “strict scrutiny” test, requiring the local government to show that the regulation serves a “compelling governmental interest.” See *Construction Industry Association of Sonoma County v. City of Petaluma*, 522 F.2d 897, 906 (9th Cir. 1975), *cert. denied*, 424 U.S. 934.

²⁴See, e.g., Longtin’s California Land Use, 2002 Update at §1.32[3], pp. 27-29.

requirement is attacked on equal protections grounds it will probably be in a case where challengers allege *unequal application* of the requirement to a specific development.

Accordingly, inclusionary requirements should be based on established facts and sound analysis of the need for affordable housing and adopted and implemented so as to apply uniformly and across the board to all similarly situated developers. And, all exemptions, exemption procedures and categories of alternative performance should have a clear basis and clear standards for eligibility.

Inclusionary Housing and its Impact on Housing and Land Markets

By David Rosen

What Effect Has Inclusionary Housing Had on Housing Production in California Cities?

To determine if inclusionary housing programs are associated with a decline in housing production, the author compiled data on annual housing starts over a 20-year period in California. For the period 1981 through 2001, annual new construction residential building permit figures for 28 cities-with and without inclusionary housing programs-located in Los Angeles, Orange, San Diego, San Francisco and Sacramento counties were reviewed. The author also analyzed housing start data for the State of California for the same period. The analysis includes separate tabulations for single family and multifamily housing starts.

The annual housing start data were then compared to passage of the 1986 Tax Reform Act (which significantly reduced favorable tax treatment for the construction of market-rate investment property) and key economic indicators: the prime rate, the 30-year mortgage rate, the unemployment rate and area median home price.

An analysis of these data shows that for the jurisdictions surveyed, adoption of an inclusionary housing program is not associated with a negative effect on housing production. In fact, in most jurisdictions as diverse as San Diego, Carlsbad and Sacramento, the reverse is true. Housing production increased, sometimes dramatically, after passage of local inclusionary housing ordinances.

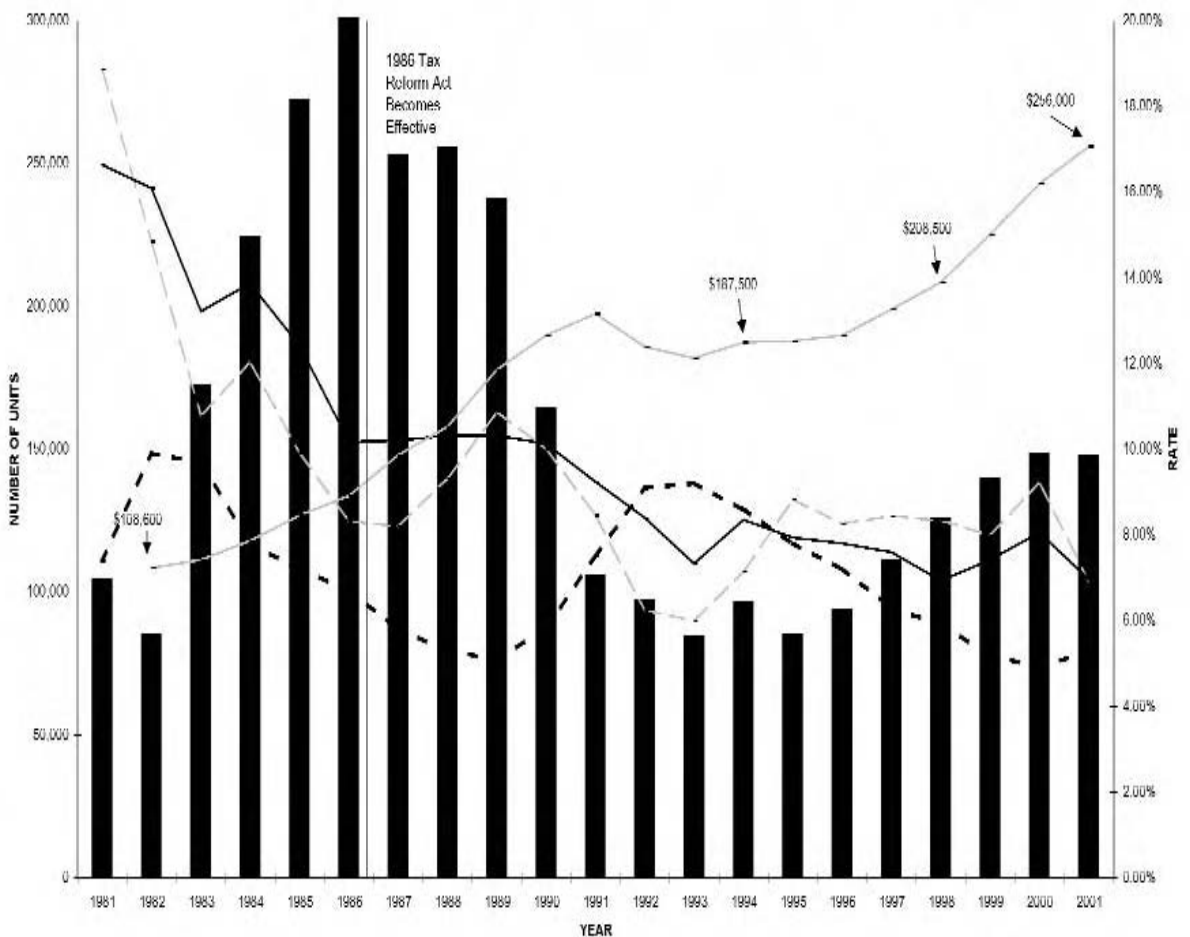
In only one of the cities surveyed, Oceanside, did residential building permit activity drop immediately after passage of inclusionary zoning (from 1,430 units in 1991 to 536 units in 1992). Although the inclusionary housing ordinance adopted in 1991 may have had some effect, other factors may have had a more important impact on housing production. The Gulf War (1990-91) dramatically increased vacancy rates in Oceanside, which is located next to United States Marine Corps Camp Pendleton. According to Margery Pierce, Director of Housing and Neighborhood Services for Oceanside, the vacancy rate increased to approximately 17 percent during that war. Second, the San Diego County unemployment rate increased steadily beginning in 1990 through 1993. In fact, housing starts were down during the same years for other cities in San Diego County: Escondido, Carlsbad, Chula Vista and San Diego itself.

A review of the data indicates that the one factor that most clearly tracks housing production is the unemployment rate. For most jurisdictions, there is an inverse relationship between the county unemployment rate and housing production. In Los Angeles, housing production figures have an inverse relationship with the Los Angeles County unemployment rate. For example, beginning in 1989 and through 1993, the increase in the Los Angeles County unemployment rate tracks the dramatic decrease in new housing production. Modest increases in new housing production did not occur until the late 1990s. Unemployment steadily dropped beginning in 1994 and continued to drop through 2000. The unemployment rates in Orange, San Diego, San Francisco and Sacramento Counties as well as the state follow similar patterns.

The passage of the 1986 Tax Reform Act is associated with a sharp drop in new housing production. The act ended favorable tax treatment of market-rate rental housing, which effectively subsidized that housing. In almost all jurisdictions surveyed, housing production figures dropped significantly after 1986. In Los Angeles, the highest number of residential units (as measured by building permits) was developed in 1986. After 1986, housing production figures dropped dramatically until a small upward trend in production beginning in the mid to late 1990s. Carlsbad is another example of a city that experienced a dramatic drop in housing production in 1987. In most instances, the drop in housing production after 1986 was not immediate. Therefore, it may be a combination of the recessionary period beginning in the early 1990s and the 1986 Tax Reform Act that dampened production of housing.

Chart 1 summarizes residential building permit figures over time for the State of California.

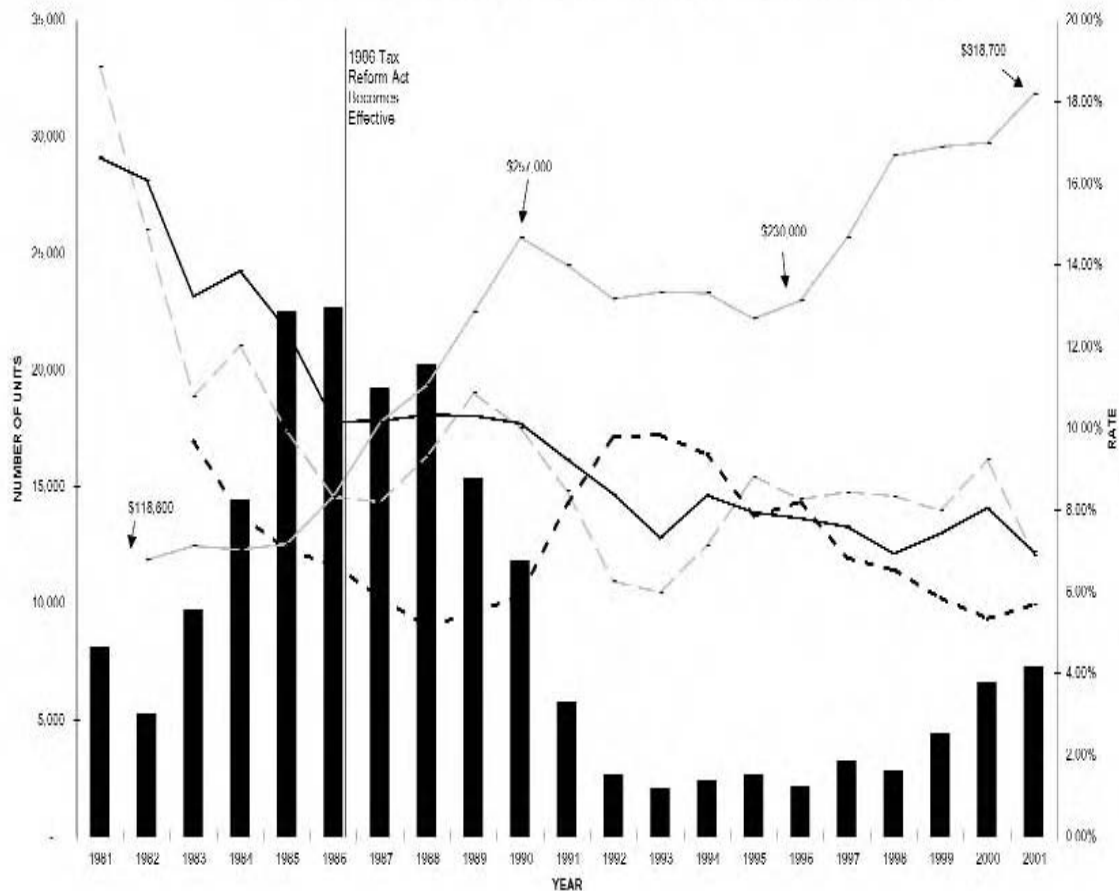
Chart 1: STATE OF CALIFORNIA TOTAL RESIDENTIAL BUILDING PERMIT ACTIVITY, 1981-2001



Sources: David Paul Rosen & Associates, Oakland, California
 Residential Permit Data - Construction Industry Research Board
 Unemployment Rate - Employment Development Department, Labor Market Information
 Prime Rate - Federal Reserve Board
 30 Year Mortgage Rate - Federal Home Loan Mortgage Corporation (FHLMC) Survey of Major Lenders
 Median New Home Price - Construction Industry Research Board

Chart 2 shows the residential building permit figures for the City of Los Angeles.

Chart 2: CITY OF LOS ANGELES TOTAL RESIDENTIAL BUILDING PERMIT ACTIVITY, 1981-2001

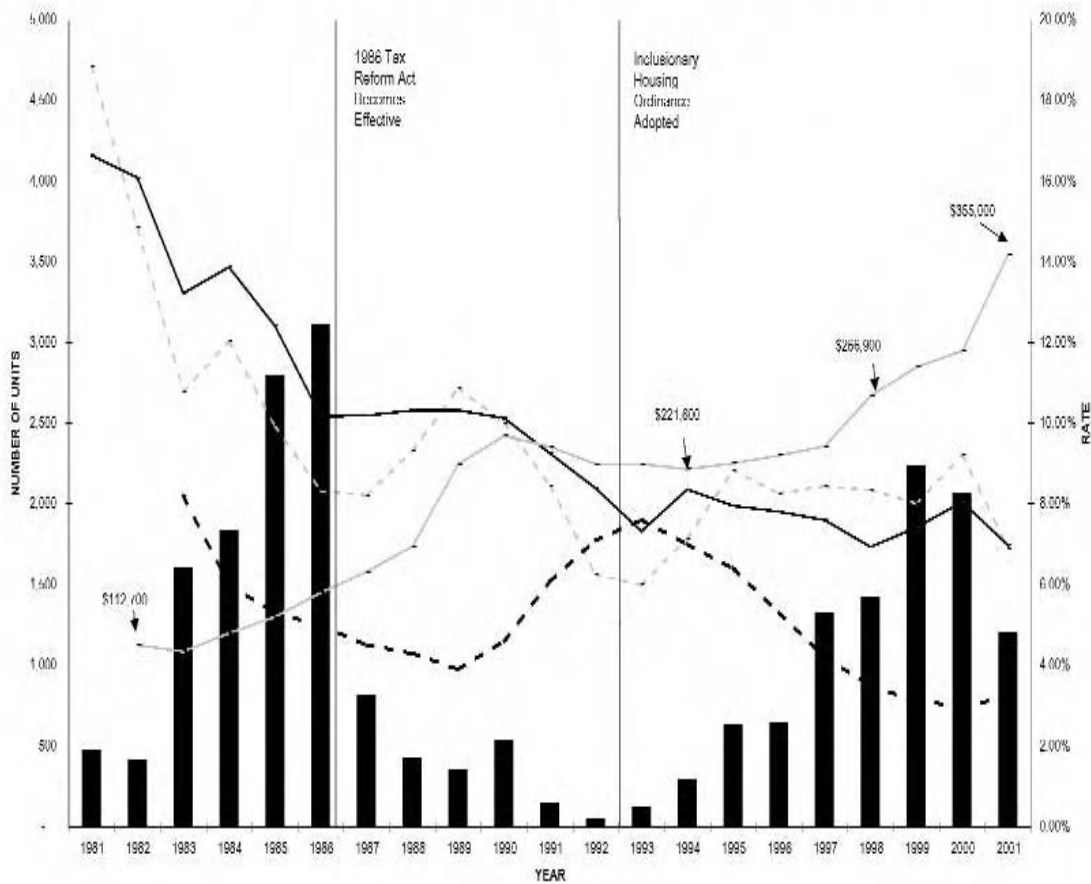


Sources: David Paul Rosen & Associates, Oakland, California
 Residential Permit Data - Construction Industry Research Board
 Unemployment Rate (seasonally adjusted) - Employment Development Department, Labor Market Information
 Prime Rate - Federal Reserve Board
 30 Year Mortgage Rate - Federal Home Loan Mortgage Corporation (FHLMC) Survey of Major Lenders
 Median New Home Price - Construction Industry Research Board (CIRB provides data by county, not city)

Chart 3 displays trends in the City of Carlsbad (one city in San Diego County with inclusionary housing).

In conclusion, after reviewing 20 years of building permit history for both multifamily and single family housing in 28 California jurisdictions plus the state itself, no correlation whatsoever was found between a city's adoption of inclusionary housing and a reduction in housing development activity.

Chart 3: CITY OF CARLSBAD TOTAL RESIDENTIAL BUILDING PERMIT ACTIVITY, 1981-2001



Sources: David Paul Rosen & Associates, Oakland, California
Residential Permit Data - Construction Industry Research Board
Unemployment Rate - Employment Development Department, Labor Market Information
Prime Rate - Federal Reserve Board
30 Year Mortgage Rate - Federal Home Loan Mortgage Corporation (FHLMC) Survey of Major Lenders
Median New Home Price - Construction Industry Research Board

Measuring the Cost and Feasibility of Inclusionary Housing

In order to assess the potential impact of alternative inclusionary housing requirements and incentives, one needs to start with basic information on how housing actually gets built in a city today. Using information from developers, one can establish the economic assumptions, development prototypes and incentives to be used in the analysis.

The approach takes care to quantify the cost of imposing an inclusionary obligation on housing developers. The approach also measures the economic value of various incentives and alternative compliance options a city may provide to offset this cost.

Inclusionary housing imposes a prospective cost on development which can be partially to completely offset with economic incentives and alternative compliance options. We determine whether and to what extent the cost of alternative inclusionary requirements can be offset by the value of incentive “packages.”

This analysis assists policymakers in making informed decisions about inclusionary housing for their communities. A land residual value analysis is used to measure these effects.

Some policymakers and developers concerned with the adoption of inclusionary housing assert that it will drive up the price of apartments and homes. This assertion is belied by the fundamentals of real estate market supply and demand. The price of housing is not a function of its development cost. Rather, housing price, be it rents or sale prices, are solely a function of market demand. For example, a developer may experience an increase in construction interest from that contained in his or her development pro forma. That developer can no more pass along the “cost increase” of higher than projected interest rates to renters or homebuyers than could be done for a “cost increase” associated with inclusionary housing. Similarly, if the price of lumber or steel experiences a sharp increase during a project’s construction, it too cannot be passed on in the form of higher rents or home prices. Conversely, no one expects a developer enjoying lower than projected interest costs to lower rents or home prices accordingly.

Why Was a Land Residual Approach Used?

Land residual analysis is commonly used by real estate developers, lenders and investors to evaluate development financial feasibility and select among alternative uses for a piece of property. The land residual methodology calculates the value of a development based on its income potential and subtracts the costs of development and developer profit to yield the underlying value of the land. An alternative land use that generates a negative land value is not financially feasible. Similarly, an alternative use which generates a land value lower than the land seller is willing to accept is infeasible. Recent land sales (“market comparables”) provide an indication of the range of land prices sellers may accept for different types of land.

Land residual analysis is the most realistic way to view the potential impact of inclusionary requirements on residential development. Developers and landlords already charge the maximum rents and sales prices the market will bear. Therefore, any increase in development costs resulting from government regulation or other factors, will ultimately impact the price of land and/or profits to developers and owners, and cannot

be passed on to the consumer. A reduction in developer profit margins does not necessarily render a project infeasible. Developers typically have “threshold” profit and overhead requirements. When developers reach their maximum profit thresholds, the price they will pay for a given land parcel will be reduced.

In some market climates, developers are willing to build and lenders and investors are willing to finance a development based on a “future value.” One example of such “speculative” development is constructing apartments which may later be sold as condominiums.

What Are the Low, Middle and High Rent/ Land Value Scenarios?

In large cities, residential land sales prices vary widely in different locations. The land prices are tied to the market rents and/or sales prices in different market areas of a city. For the Los Angeles analysis, the author analyzed actual land sales prices for 79 residential developments receiving building permits in the City of Los Angeles in 2001.

The market land sales comparables were divided into thirds based on price per square foot of site area to represent *low*, *middle* and *high* land price ranges in the City. For the rental land residual analysis, the author used *low*, *middle* and *high* average rent data from 45,000 rental units (*RealFacts*, 2002) to calculate rents for the three (low, middle and high) rent/land values scenarios.

Prototype: Los Angeles

Chart 4 illustrates one set of land residual value findings applying this methodology to the City of Los Angeles. A rental residential development prototype is shown in this chart: a 30-unit infill project of stacked flats at 25 units to the acre with covered parking at grade. In this case, the market-rate prototype in the lowest third of land comparable values and rents for Los Angeles yields a residual land value of approximately \$17 a square foot. Setting aside 10 percent of the units affordable to families at 45 percent of the 2003 area median income (approximately \$25,000) yields a residual land value of \$12 a square foot, with no offsets. A 25 percent density bonus, as required by California state law, yields a residual land value higher than the market-rate prototype: \$20 a square foot. For middle-tier rents and land values, the market-rate prototype yields a land value slightly below land comparables, and suggests that a developer/buyer and land seller may not come to terms on land price for this project. However with the affordable set-aside of inclusionary housing and a 25 percent bonus, land value increases above that for the market-rate project to competitive prices (\$27 a square foot).

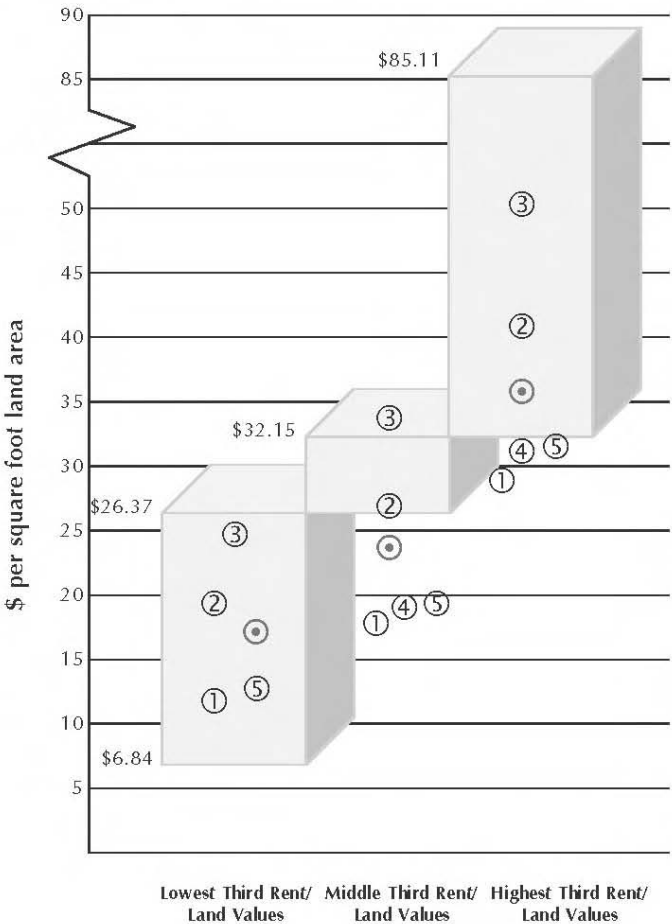
For the Los Angeles analysis, most of the 10 prototypes analyzed yielded market comparable land values. Exceptions were adaptive reuse of existing commercial buildings, where no density bonus or parking concessions could reasonably be applied, and high-rise steel frame construction where luxury rents and home prices were not modeled. Los Angeles has seen no high-rise steel frame construction housing in recent years, with the exception of Marina Del Rey, a luxury oceanfront location.

Los Angeles Inclusionary Housing Economic Impact Analysis

Land Residual Values Based on Alternative Incentive/Compliance Options

Chart 4

Renter Prototype:
Type V Low Density Construction



KEY: Incentive/Compliance Options *

- ① No offsets
- ② 25% density bonus; fee deferrals; affordable unit modifications
- ③ 50% density bonus; fee deferrals; affordable unit modifications
- ④ Off-site compliance; fee deferrals; affordable unit modifications
- ⑤ Multifamily acquisition/rehabilitation compliance; fee deferrals
- ⊙ Market-rate prototype

The \$6.84-\$85.11 represents actual land sale comparables in Los Angeles for residential projects permitted in 2001.

* All options require 10% of total units to be affordable to households at 45% of the area median income; approximately \$25,000 for a household of four in Los Angeles, 2002.

Chart prepared for the Los Angeles Housing Department.

DAVID PAUL ROSEN & ASSOCIATES

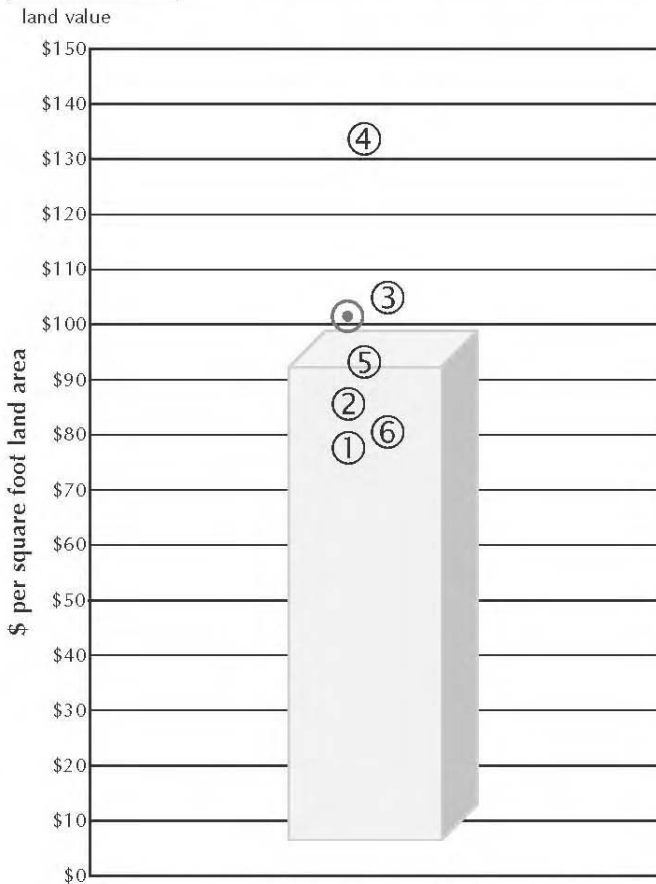
Prototype: Long Beach

Similar results were found for a comparable study in the City of Long Beach. **Chart 5** shows an owner condominium prototype of Type V stack flat condominium construction at 70 units to the acre with one level of subterranean parking. Here, the affordability set-aside is 15 percent of the units at 90 percent of the area median income, or \$50,000 for a family of four in Long Beach in 2003. The market-rate prototype, without inclusionary requirements, yields a land value of \$100 a square foot, slightly above the top of the range of recent land sales in the City. The set-aside requirement, with no offsets, reduces land value to approximately \$78 a square foot, still near the top of the range of land sale comparables in Long Beach. When incentives and/or offsets are added, land values approach, and exceed, the market-rate prototypes' land value.

Long Beach Inclusionary Housing Economic Impact Analysis Land Residual Values Based on Alternative Incentive/Compliance Options

Chart 5

Owner Prototype:
Type V Stacked Flat Condos



KEY: Incentive/ Compliance Options *

- ① No offsets
- ② Fee deferrals;
affordable unit modifications
- ③ 25% density bonus;
fee deferrals;
affordable unit modifications
- ④ 50% density bonus;
fee deferrals;
affordable unit modifications
- ⑤ Off-site compliance;
fee deferrals;
affordable unit modifications
- ⑥ Multifamily acquisition/
rehabilitation compliance;
fee deferrals;
affordable unit modifications
- ⊙ 100% Market-Rate Units

The bar represents actual recent residential and planned development land sales comparables and appraised values in Long Beach between 1998 and 2003 ranging between \$13 to \$99 per square foot. When the bulls-eye and numbered dots fall within the bar areas, the residual land values generated by the prototype and "package" option are within the range of recent land sales comparables in Long Beach, and should generally be reviewed as financially feasible.

* All options require 15% of total units to be affordable to households at 90% (45% for package 6) of the area median income; approximately \$50,000 for a household of four in Long Beach, 2003.

In both the Los Angeles and Long Beach analyses, it is important to note that conservative (i.e., high) assumptions regarding developer profit, overhead and interest rates were used. Developer profit and overhead was modeled at 16 percent; construction and permanent interest rates were modeled at 8.5 percent and eight percent respectively. Developer profit is often acceptable as low as eight percent and market interest rates as of this writing are more than two points lower than that modeled. Thus, land residual values are understated, as is the economic feasibility of the inclusionary housing set-asides shown.

Furthermore, holding developer profit constant in this illustration has the effect of assuring an acceptable profit margin. In the real world of land sellers (land owners) and land buyers (developers), land price is a delicate negotiation between the two parties, each seeking to maximize their own profit. If development costs, be they associated with construction interest rates, the price of lumber or steel or the projected costs of inclusionary obligations, are excessive, land buyers and sellers may agree to part company without concluding a sale. We have shown an approach to balance the cost of inclusionary housing obligations against the economic value of a variety of incentives, offsets and alternative compliance provisions. When the combined effect of such costs and incentives does not reduce current comparable land values by more than 10 to 20 percent, the policy package may be deemed economically feasible in a given jurisdiction. Land prices, with no public sector intervention whatsoever through the zoning or regulatory process, readily fluctuate 10 to 20 percent in any given rolling 12-month period. Thus, a projected effect of 10 to 20 percent on land values may be seen as operating within the normal limits of real estate land values within relatively short business cycles.

The land residual value methodology applied to inclusionary housing economic analysis helps policymakers and stakeholders craft inclusionary housing set-aside requirements which maximize the yield of affordable units without unduly restricting land value or developer profit.

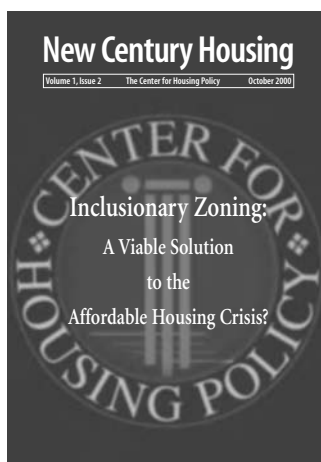
Real estate development is a customized process. No project is the same. Thus, citywide analysis may only be properly modeled through prototypes fully representative of the range of housing product developed in that jurisdiction. Political constraints may also restrict the application of various incentives or alternative compliance provisions for an inclusionary housing program. For example, while a density bonus may be offered, if limits on height, floor area ratio or set backs render such a density bonus unusable, it will prove of little value to developers. Similarly, if neighborhood or political opposition forces developers to scale back or eliminate their projects, then prototypical analysis becomes an academic exercise. Development, like politics, is the art of the possible.

Nevertheless, empirical analysis uncovers no chilling effect of inclusionary housing on California jurisdictions which have adopted the program. More importantly, the land residual economic methodology shows that policymakers can craft inclusionary programs which fall within the range of economic feasibility.

Long-term, perhaps no other single local housing policy is more valuable in the production of affordable housing. For the period 1981 through 2001, approximately 190,000 units were built in Los Angeles. If the City had a 15 percent set-aside requirement, throughout that time, 28,500 units of affordable housing would have been constructed.

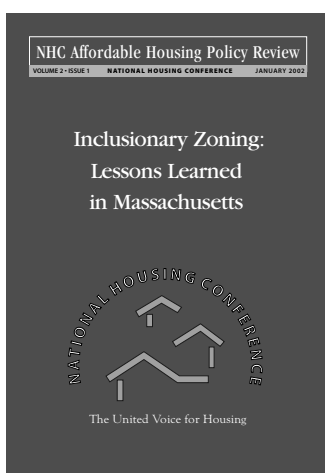
Additional National Housing Conference Inclusionary Zoning Publications

The following reports are available online at www.nhc.org.



Inclusionary Zoning: A Viable Solution to the Affordable Housing Crisis?

This issue of *New Century Housing* focuses on inclusionary zoning as a tool that could be applied at the state or local level to address affordable housing needs and highlights the steps taken to implement inclusionary zoning policies in Montgomery County, Maryland.



Inclusionary Zoning: Lessons Learned in Massachusetts

This issue of *NHC Affordable Housing Policy Review*, a collaborative effort between the National Housing Conference and the Massachusetts Housing Partnership Fund, explores the issue of inclusionary zoning by reviewing the experiences of select cities and towns in Massachusetts where inclusionary zoning has been used to produce affordable housing.

The contributing authors of both publications represent some of the best minds on the topic of inclusionary zoning. They include academics, local program administrators, as well as housing developers. Their differing perspectives help to provide a balanced view of the strengths, weaknesses, successes and limitations of this approach.



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