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Redevelopment Journal

October 2004, Number 284

A monthly publication of the California Redevelopment Association

Measuring the Economic Feasibility of Inclusionary Housing in California

by David Rosen, Ph.D.
David Paul Rosen & Associates

According to a 2003 statewide survey conducted by the Northern California Association for Non-Profit Housing (NPH), over the last 30 years more than 100 California cities and counties - about 20 percent of all jurisdictions in the State - have produced more than 34,000 units of affordable housing as a direct result of their inclusionary housing programs.

Inclusionary housing - the practice of requiring a percentage of all new market rate housing developed be set-aside as affordable housing to specified income groups - is both a widespread and growing public policy in California cities and counties. Many redevelopment agencies play an active role in their communities' inclusionary housing program, and use this program to help meet State requirements for affordable housing production within redevelopment project areas. This article discusses the effect of these programs on housing production. It also reviews the methodology that can be used to measure the economic feasibility of a community's inclusionary housing program.

With the exception of 20% housing set-aside provided by redevelopment tax increment, inclusionary housing is perhaps the most effective tool for a local policy maker to use for the production of affordable housing. For example, from 1981 through 2001, approximately 190,000 units were built in Los Angeles. If Los Angeles had a 15 percent set-aside requirement during that period, 28,500 units of affordable housing would have been created.

Proponents of inclusionary housing, pointing to the additional 34,000 affordable housing units produced because of inclusionary housing, claim the program represents one of the most meaningful responses to California's persistent affordable housing crisis. Opponents claim that inclusionary housing either will stop or slow overall housing development, and that it will increase the price of housing to homebuyers and renters.

To measure the effect inclusionary housing has on housing production in California, David Paul Rosen & Associates (DRA) compiled data on annual housing starts over a twenty-year period to determine if inclusionary housing programs are associated with a decline in housing production. For the period 1981-2001, DRA reviewed annual building permit data for 28 California cities – 14 cities with inclusionary housing programs and 14 cities without inclusionary housing programs.

DRA also analyzed statewide housing start data for the same period. 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

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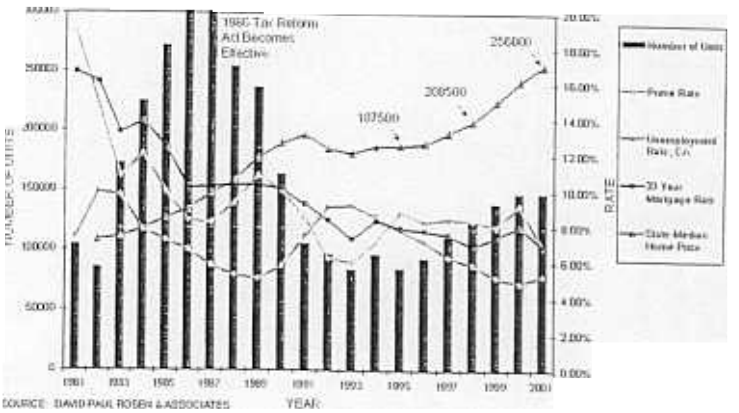
unemployment rate, and area median home price. Chart 1 summarizes the data collected.

An analysis of the data shows that the adoption of an inclusionary housing program is not associated with a negative effect on housing production. In fact, the reverse is true for most jurisdictions. Housing production increased, sometimes dramatically, after passage of local inclusionary housing ordinances. In addition, 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.

DRA also analyzed the potential impact of different inclusionary housing requirements and incentives based on how housing gets built in a city. Based on economic assumptions, housing development prototypes (single-family, condominiums, townhouses, etc.), and incentives, DRA developed a land residual value methodology that analyzes and measures the cost of different inclusionary requirements against the value of incentive "packages" to offset costs or otherwise provide incentives to market-rate housing. By applying this methodology, policy makers and stakeholders can craft inclusionary housing requirements that can maximize the yield of affordable units without unduly restricting land value or developer profit.

Real estate developers, lenders, and investors have long used land residual value analysis to evaluate the financial

CHART 1
STATE OF CALIFORNIA RESIDENTIAL BUILDING PERMIT ACTIVITY



feasibility of developing a piece of property based on different uses. This 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. A land use that generates a land value that is negative or is lower than the land seller is willing to accept is not feasible.

Land residual value analysis is the most realistic way to view the potential impact of inclusionary requirements on residential development. If we assume that developers and landlords already charge the maximum rents and sales prices the market will bear, then 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.

To demonstrate how land residual value findings can be applied to a city, this methodology was applied to the City of Los Angeles. Actual land sales prices were analyzed for all 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, low, middle, and high average rent data from 45,000 rental units were used to calculate rents for the three rent values scenarios.

Chart 2 illustrates one set of land residual value findings applied to the City of Los Angeles for a residential rental development prototype (Type V – Low Density Construction). The chart analyzes a 30-unit in-fill 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 rent and land values 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% density bonus, as required by California state law, yields a

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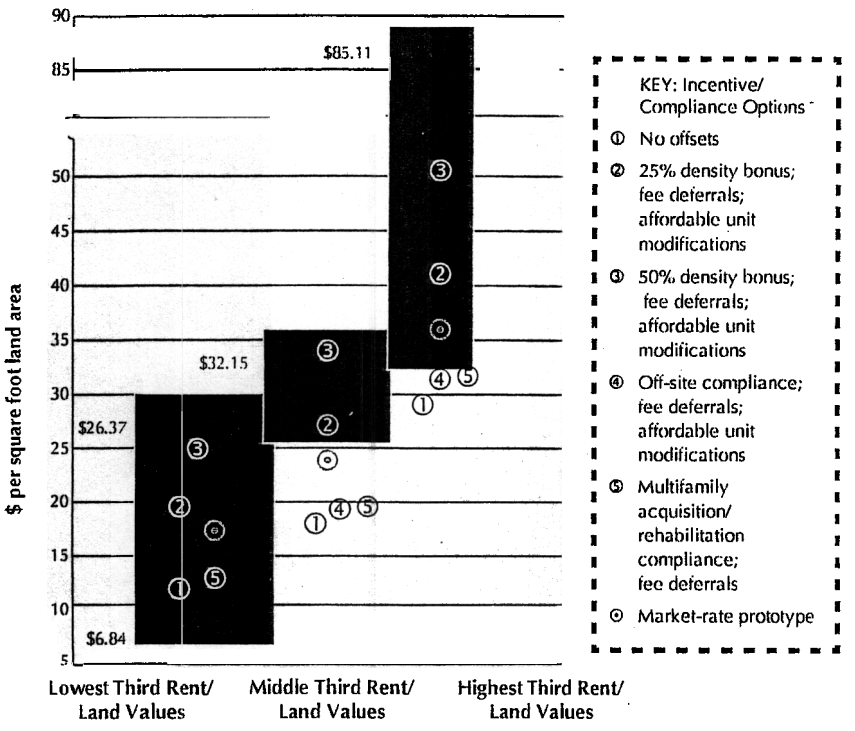
Los Angeles Inclusionary Housing Economic Impact Analysis
Land Residual Values Based on Alternative Incentive/Compliance Options

Chart 2

Renter Prototype 1:
Type V Low Density Construction



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.

residual land value of $20 a square foot, which is higher than the market rate prototype of $17 a square foot. For the middle third of 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% bonus, land value increases above that for the market rate project to a competitive price of $27 a square foot. A similar analysis can also be made for the highest third of rent and land values.

The Los Angeles analysis show that most of the 10 prototypes analyzed yielded market comparable land values. Similar results were found for comparable studies conducted throughout California.

Real estate development is a customized process. No project is the same. Thus, citywide analysis may only be properly modeled through prototypes that represent the full range of housing product developed in a jurisdiction. Inclusionary housing programs should also be tailored to fit market and policy patterns in a jurisdiction.

DRA's analysis uncovers no chilling effect of inclusionary housing on market rate housing production in California jurisdictions which have adopted the program. More importantly, the land residual economic methodology shows that policy makers can craft inclusionary programs which fall within the range of economic feasibility.

David P. Rosen founded David Paul Rosen & Associates (DRA) in 1980. DRA is a national real estate economic and public policy consulting firm based in Oakland and Irvine, California. For further information, go to the DRA website at www.draconsultants.com. R.J

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