ISSUES ASSOCIATED WITH THE IMPOSITION OF INCLUSIONARY ZONING IN THE PORTLAND METROPOLITAN AREA

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ISSUES ASSOCIATED WITH THE IMPOSITION OF INCLUSIONARY ZONING IN PORTLAND OREGON

EXECUTIVE SUMMARY

The impacts of inclusionary zoning regulations should be fully understood before a community determines the appropriateness of implementing such fees. This study was commissioned to present a formal discussion of the major issues surrounding inclusionary zoning as it relates to the Oregon portion of the Portland metropolitan area.

Inclusionary zoning is a requirement mandating that a particular number or percentage of “affordable” housing units be built in order to be granted development approval. The variation being evaluated in the Portland area would apply to residential developments greater than 10 units, and require a developer to deliver 20% of his units at a price considered affordable for a households earning 80% of the region’s median income.

The following is a summary of the key conclusions of our analysis:

Key Conclusions

• Inclusionary zoning requirements function as a tax on new development. This “tax”, or the cost of providing the below-market housing units, is passed on to the consumer and the landowner. Over the long run, developers will not bear the cost of this tax. Dr. Arthur O’Sullivan, with Oregon State University’s Department of Economics, summarizes the impacts of inclusionary zoning.

  “Who pays for inclusionary zoning? The requirement of subsidized housing has the same effect as a development tax.” “The developer makes zero economic profit with or without inclusionary zoning, so the implicit tax is passed on to consumers (housing price increases) and landowners (the price of vacant land decreases). In other words, housing consumers and landowners pay for inclusionary zoning”

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• Through taxing the production of new housing units, the economic impact of inclusionary zoning would be a reduction in housing production. This would be expected to place inflationary pressure on the entire spectrum of market-rate housing in the region.

The primary intent of inclusionary zoning is typically to increase the inventory of affordable housing in the metropolitan area. The more likely scenario is a reduction in overall housing opportunities for low income residents. In the Portland metropolitan area, the anticipated economic impacts of inclusionary zoning would be as follows:

- **A Reduction in Housing Supply**
- **Rising Market Rents**
- **A Diversion of Housing Demand**

While attention has focused on subsidized housing programs, general market trends have had a much more substantial impact on the inventory of housing units affordable to low income households. Over the last two years, we estimate that the stock of homes in the metropolitan area priced at $125,000 and below was reduced by 80,000 units. In the rental apartment market, a 10% rise in rent levels reduced the number of units available for under $500 per month by almost 20,000 units.

The anticipated inflationary impacts of inclusionary zoning are likely to more than compensate for any units gained, and actually decrease the stock of housing affordable to the targeted income groups. If inclusionary zoning was implemented, and future development activity was consistent with recent trends, roughly 1,032 single family and 565 multi-family “affordable” housing units would be mandated per year. The 565 unit annual gain in multi-family units attributable to the program would be offset by an overall loss in units available at these rent levels in the region by a mere 0.28% increase in rent levels.

Inclusionary zoning represents a highly inequitable tax. The metropolitan area’s affordable housing problems reflect a regional problem, and have been at least partly attributable to regional policy decisions. Shifting the burden of affordable housing provision to new residential development has no equitable basis.

The most likely impacts of inclusionary zoning will be largely regressive. One of the largest equity concerns is that implementation of inclusionary zoning may transfer wealth from new residents and apartment dwellers to existing homeowners and income property owners. The upward pressure anticipated on housing prices and rents would favor existing homeowners and owners of rental apartment projects, while negatively impacting renter households.

The following is a summary list of the anticipated winners and losers if mandatory inclusionary zoning is implemented in the Portland metropolitan area:

<table>
<thead>
<tr>
<th>Winners</th>
<th>Losers</th>
</tr>
</thead>
<tbody>
<tr>
<td>20% of Low-Income Households in Subsidized Stock</td>
<td>80% of Low-Income Households in Market Rate Stock</td>
</tr>
<tr>
<td>Income Property Owners/Investors</td>
<td>Other Renters</td>
</tr>
<tr>
<td>Existing Home Owners (Retirement)</td>
<td>Home Buyers</td>
</tr>
<tr>
<td>Non-Profit Housing Providers?</td>
<td>Landowners</td>
</tr>
<tr>
<td>Developers?</td>
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• As an unintended consequence, the majority of low-income households would be harmed by the imposition of mandatory inclusionary zoning in the area. Inclusionary zoning is effective only if viewed through the limited criteria of creating subsidized housing units. When viewed in the broader context of the overall housing market, mandatory inclusionary zoning would be expected to reduce the stock of housing available to low income households substantially.
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I. Introduction

The impacts of inclusionary zoning regulations should be fully understood before a community determines the appropriateness of implementing such fees. This study was commissioned to present a formal discussion of the major issues surrounding inclusionary zoning as it relates to the Oregon portion of the Portland metropolitan area.

Inclusionary zoning is a requirement mandating that a particular number or percentage of “affordable” housing units be built in order to be granted development approval. Common variations include a buy-out option, in which a developer puts money into a trust for development of affordable housing rather than build units, and tradable development rights, in which a developer contracts with a public or private agency to have affordable units constructed off-site. The variation being evaluated in the Portland area would apply to residential developments greater than 10 units, and require a developer to deliver 20% of his units at a price considered affordable for a households earning 80% of the region’s median income.

The stated intent of inclusionary zoning is to increase the inventory of affordable housing in the metropolitan area.

II. Economic Characteristics of Inclusionary Zoning

Inclusionary zoning requirements function as a tax on new development. By mandated that a component of a residential development be set aside at a reduced price point, inclusionary zoning changes the financial characteristics of real estate developments and the development process. Inclusionary zoning reduces the saleable value of the development upon completion, which would lower the return to the developer without adjustments in the price paid for land and/or the price charged for the remaining product.

When evaluating the anticipated impact of inclusionary zoning regulations, one of the key variables to be considered is the degree to which cost shifting occurs. While the inclusionary zoning requirements are placed on a developer, the cost associated with the requirements can be transferred to the buyer of the remaining residential units through a higher purchase price, absorbed by the developer through a lower profit margin, or deducted from the value of the land. The degree to which cost shifting occurs determines the actual incidence of the charge, or who pays the costs associated with providing the affordable housing units.

Our analysis will evaluate anticipated impacts associated with inclusionary zoning by applying economic principals to the development process. The development process serves as the medium through which market demand (growth in households and employment by type) is translated into development products or types. The development process represents a rational, and therefore
largely predictable, response to what we refer to in this document as the development environment. The development environment includes a large number of participants, including:

- Developers (individuals, corporations, non-profits, etc.);
- Land owners (individuals, corporations, etc.);
- Lenders (banks, insurance companies, pension funds, etc.);
- Equity contributors (insurance companies, pension funds, etc.);
- The “market” (households and potential lessees); and
- Governmental agencies (local, regional, state, etc.).

Developers serve as the primary drivers of the development process, typically initiating development projects. The developer makes a living through managing risk, evaluating the probable financial return on a project in light of assumed risk. Developers cannot be expected to initiate a development in which the risk to return ratio is not compelling. Both lenders and equity contributors will also evaluate any development opportunity proposed by a developer using similar criteria. The “market” is the customer or end-user in the development process, and will largely dictate to the developer what is desirable and what they are willing to pay for the end product (either through purchase price or lease rate). Governmental agencies typically define the legal and bureaucratic process under which property is developed, and can influence the marketplace by incentives and/or restrictions.

The interaction of participants outlined above produces several definable characteristics of the development environment. These include: the expected rates of return required for developers and equity contributors for alternative degrees of risk assumed; the interest rate, fees and equity required by the lender; the selling price or lease rate that the market is willing to pay for alternative products; fees and exactions required by governmental agencies; and the types of development allowed by governmental agencies.

If inclusionary zoning is instituted, the short-term and long-term effects are expected to vary considerably. In the short term, developers are expected to bear a large share of the cost, passing whatever proportion they can on to the consumer. If the land has already been purchased, the developer will not have the option to pass some of the cost to the landowner. The likely impact would be a reduction in profit margin for the developer, or a loss if the charges were high enough.

Assuming a competitive market, the developer would be expected to maintain a stable profit margin over the long term. The developer’s profit margin reflects what he considers to be an adequate return in light of the risk he assumes initiating the development. In order to maintain an adequate return, the developer will need to shift the cost of the charge to the buyer and/or the landowner. The direction and magnitude of this shift is a key variable in assessing the impact of inclusionary zoning.

The incidence of the fees depends on how much of the charge is passed on to the consumer or back to the landowner. In a normally functioning market, economic theory would predict that the cost of providing the affordable housing units would largely be shifted back to lower land prices. Everything else equal, developers would not be willing to pay as much for land if they also has a
mandate to provide affordable housing units. If landowners have alternative uses for land, such as farming, then somewhat less land may become available for development; but if all land in a jurisdiction is likely to be developed, capitalization into land prices is a likely outcome. Shifting costs to the market is problematic, as the project must compete with a larger market that was not subject to the inclusionary zoning mandate.

While shifting costs to the landowner would be the most likely outcome in a normally functioning market, the Portland metropolitan area’s land market is currently constrained, allowing landowners a stronger negotiating position. As a result, it will be difficult for developers to negotiate a lower land value that would allow them to offset the impact of the inclusionary zoning requirements. Dr. Arthur O’Sullivan, with Oregon State University’s Department of Economics, summarizes the impacts of inclusionary zoning.

“Who pays for inclusionary zoning? The requirement of subsidized housing has the same effect as a development tax.” “The developer makes zero economic profit with or without inclusionary zoning, so the implicit tax is passed on to consumers (housing price increases) and landowners (the price of vacant land decreases). In other words, housing consumers and landowners pay for inclusionary zoning.”

In the Portland metropolitan area, the anticipated economic impacts of inclusionary zoning would be as follows:

- **Reduction in Housing Supply** - By increasing the cost of new development, the amount of housing supplied by the market would be expected to decrease.
- **Rising Market Rents** - The increased cost of new development, in conjunction with a reduction in new supply, will place inflationary pressure on residential rents and home prices.
- **Housing Demand Diverted** - Higher housing and development costs within the Metro boundary would increase the attractiveness of communities on the periphery, such as Newberg, Woodburn, and Clark County. These communities would be expected to capture a greater share of regional growth, increasing commuting distances and vehicle miles traveled.

### III. Residential Market Impacts

Implementing an inclusionary zoning mandate on new residential development would be expected to impact the price and quantity of housing units sold in the market. This section introduces many of the probable impacts on affordability in the residential markets.

**Recent Trends**

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Recent market trends are indicative of a shift in the distribution of home sales. The following chart illustrates this trend, in which the low-end of the market declines dramatically while the remaining price segments reflect a less pronounced rate of escalation. This home price escalation pattern is consistent with what we would expect in a land-constrained situation, which places price pressure on existing housing stock, which historically serves as the region’s primary source of affordable housing.

The percentage of homes priced under $125,000 in the area dropped from 52% of the market to 35% of the market during this period. When applied to the region’s stock of single family homes, this translates into a reduction of 80,000 units in that price range over the last two years. Rising
home prices are directly correlated with rising rent levels. A 10% rise in effective rental rates would reduce the number of rental apartments available in the region under $500 per month by almost 20,000 units. The region does not have the means to address impacts of this magnitude with affordable housing programs.

Over the last six and a half years, which represented an unusually brisk pace of development, residential permits in the Oregon portion of the Portland metropolitan area averaged 6,450 single family and 3,530 multi-family. Assuming 80% of new residential projects were subject to the inclusionary zoning requirements proposed, and development continued at the recent pace, a total of 1,032 single family and 565 multi-family units would be required to meet the proscribed income requirements. The 565 unit annual gain in multi-family units attributable to the program would be offset by an overall loss in units available at these rent levels in the region by a mere 0.28% increase in rent levels. As a result, the anticipated inflationary impacts of inclusionary zoning are likely to more than compensate for any units gained, and actually decrease the stock of housing affordable to the targeted income groups. In addition, the full spectrum of the housing market will experience higher home prices.

Among the most common market misconceptions is that developers prefer to build to the higher end of the market, as it yields a higher profit margin. Under this scenario, the affordable housing problem reflects an unwillingness of developers to offer relatively low priced homes. This misconception reflects a lack of understanding of the risk/return relationship in real estate development. While the magnitude of profit on a higher-end home may be higher, the rate of return is typically similar. Developers building homes priced over $300,000 also incur significantly higher marketing risk, making their risk-adjusted yield lower. Many homebuilders would prefer to build to the entry-level market, but are forced to produce higher-priced homes by land values. With typical lot prices in the area ranging from $60,000 to $100,000 per lot, homebuilder’s are forced out of the relatively low-risk entry-level market.

IV. Equity Issues

Equitable taxation is usually stated as an objective of taxing entities. However, equity is a complex issue that means different things to different people. Two major philosophies exist on equitable taxation: Taxation should be based on the benefit principle or taxation should be based on the ability to pay. Inclusionary zoning cannot be considered equitable under either philosophy.

According to the benefit principle, an equitable tax is based on the quantity of government services used. Individuals who consume large quantities of government services should pay higher taxes since they benefit more from the tax revenue. As outlined previously, residential landowners and housing consumers are likely to pay the cost of providing the mandated affordable housing units. These same parties will not receive any direct benefits from the mandated affordable units.

The ability to pay principle suggests that the tax liability an individual faces should be based on the ability to pay (generally income based). This approach usually includes a redistribution effect.
since the primary beneficiaries of the tax revenue are not necessarily paying more tax. There is no basis to believe that the parties expected to pay the cost of inclusionary zoning, housing consumers and landowners, have a unique ability to pay.

The metropolitan area’s affordable housing problems reflect a regional problem, and have been at least partly attributable to regional policy decisions. Shifting the burden of affordable housing provision to new residential development has no equitable basis. In fact, the most likely impacts of inclusionary zoning will be largely regressive. One of the largest equity concerns is that implementation of inclusionary zoning may transfer wealth from new residents and apartment dwellers to existing homeowners and income property owners. The upward pressure anticipated on housing prices and rents would favor existing homeowners and owners of rental apartment projects, while negatively impacting renter households.

V. Conclusions

The implementation of inclusionary zoning would substantially impact real estate markets, changing the behavior of producers and consumers, and altering the growth rate of population and employment. This section provides an overview of the primary beneficiaries and losers associated with implementation of inclusionary zoning.

Beneficiaries

• Low-income households utilizing subsidized units, which typically account for 20% of qualified households.

• Non-profit housing providers, who could be expected to benefit from increased funding. The ability of these groups to benefit from inclusionary zoning would hinge upon their ability to deliver housing products at an efficiency level close to that found in the for-profit market.

• Investors owning residential income properties, which would benefit from rising rent levels.

• Existing homeowners, who would be expected to benefit from escalating home values.

• Investors owning residential income properties, which would benefit from rising rent levels.

Losers

• Low-income households in market rate rental units, estimated at 80% of qualified households, who would likely see rising rent levels and a decreasing stock of affordable units.

• All renter households, who would be expected to face rising rent levels and a decreasing ability to enter the ownership housing market.
• Home Buyers, who are expected to see rising home prices in the area.

• Developers, while maintaining their margins, are likely to face a lower level of development activity, therefore reducing their local opportunities.

As outlined in the previous list, the majority of low-income households would be harmed by the imposition of mandatory inclusionary zoning in the area. The apparent contradiction between non-profit housing providers benefiting at the expense of a majority of low-income households is not unusual, with the relationship summarized by Gerard Mildner of Portland State University:

“the interests of low-income households and non-profit housing providers are not overlapping. Federal studies have consistently pointed out that housing vouchers and portable certificates are a better way of serving the poor, while non-profit providers are better served by receiving project-based assistance. And while housing subsidies are required for all the providers’ new developments, over 80% of low-income renters find housing in the private market. Thus, the advocates represent the select 20% of low-income renters in assisted housing, not the 80% suffering from rising rents.”

Inclusionary zoning is effective only if viewed through the limited criteria of creating subsidized housing units. When viewed in the broader context of the overall housing market, mandatory inclusionary zoning would be expected to reduce the stock of housing available to low income households substantially.

REFERENCES


Housing and Community Development Commission. (1994). "Regional Growth and Affordable Housing"


