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Inclusionary Housing, Incentives, and Land Value Recapture

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Inclusionary Housing (IH) programs are land use regulations that require developers of market-rate residential development to set aside a small portion of their units, usually between 10 and 20 percent, for households unable to afford housing in the open market. Alternatively they can choose to pay a fee or donate land in lieu of providing units. Originating in the early 1970s, inclusionary housing has grown to be a major vehicle by which affordable housing units are provided in large parts of the United States, as well as an important strategy for affordable housing in many other countries.

From the first days of IH, there has been widespread debate over what is sometimes called the “incidence” controversy—that is, how the costs of providing affordable, and by definition below-

market, housing are addressed, and which of the parties in a real estate transaction actually bears those costs. As a result of widespread concern that costs are being borne by developers and/or market-rate homebuyers, and reflecting legal concerns associated with the takings issue, many municipalities enacting inclusionary ordinances have combined them with incentives or cost offsets designed to make the imposition of an affordable housing obligation cost-neutral. Many of these incentives, however, displace costs onto the public, either directly or indirectly.

We suggest that a better approach is to link inclusionary housing to the ongoing process of rezoning—either by the developer or by local government initiative—thus treating it explicitly as a vehicle for recapturing for public benefit some part of the gain in land value resulting from public action.

The La Costa Paloma Apartments in Carlsbad, California, have 180 apartment units affordable to households earning at or below 50 and 60 percent of the area median income.

The Evolution of Inclusionary Housing

Several factors contributed to the development of inclusionary housing in the early 1970s: efforts to foster racially and socioeconomically integrated communities and combat exclusionary practices; the rise of the environmental movement that spurred growth management programs; the use of exactions to make development pay for the costs of growth; and sharp housing cost increases, particularly in key areas such as California and Washington, DC. During the 1980s, IH became an important tool to offset the Reagan administration’s savage cuts in federal funding for affordable housing by pushing states and localities to take a more pro-active role in the affordable housing arena.

California, New Jersey, and Massachusetts led the nation in IH, driven by state laws enacted during this period that required local governments to produce, or remove obstacles blocking others from producing, their “fair share” of affordable housing. Outside of those states, the greater Washington, DC, region produced many of the first significant IH programs, notably in Montgomery and Prince George’s counties in Maryland, and Fairfax and Loudoun counties in Virginia.

IH was originally a tool to provide affordable housing and create mixed-income communities in

suburban areas, but today it is also being adopted in urban centers such as Denver, Baltimore, Chicago, and New York where redevelopment, infill, and densification—and often gentrification—are taking place. Some cities are also requiring developers who convert rental housing into condominiums to make a portion of the former rental units affordable to moderate- or low-income homebuyers, extending the reach of IH to existing buildings as well. Implementing IH programs becomes more problematic, however, when applied to urban infill sites and redevelopment areas, where development is often more expensive and difficult than in the suburbs, demanding particular flexibility in designing and administering IH ordinances.

No national survey has ever been conducted of IH programs. Estimates range from 300 to 500 programs in existence and 80,000 to 120,000 units produced (Porter 2004; Brunick 2007; Mallach 2009). IH may not be a panacea for the nation’s housing affordability problems, but it can be a significant, locally based component of an overarching strategy in which the federal and state governments must also play significant roles.

IH, moreover, is no longer an exclusive American practice. In recent years it has spread not only to Canada and many European countries, includ-

Part of an inclusionary development in affluent suburban Cranbury, New Jersey, this four-unit structure is designed to look like an expensive single-family house.



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The single-family developer of the La Costa Paloma Apartments in Carlsbad, California, was allowed to cluster the IH units and build them in collaboration with a nonprofit developer.

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ing England, Ireland, France, Italy, and Spain, but also to such far-flung places as India, South Africa, New Zealand, and Australia. The global spread of IH reflects a larger policy shift under which governments increasingly look to developers to shoulder part of the wider societal costs of development. But who actually pays for those costs?

The Incidence Controversy

Since it can be assumed that affordable housing units will sell or rent for below-market prices, there is little doubt that there are costs associated with complying with a municipality's inclusionary requirement. While developers often maintain that renters or buyers of market-rate units bear the cost of IH, economists point out that the developer and/or the seller of raw land to the developer should, under most circumstances, absorb part or all of these costs. There seems to be agreement in the literature that "in the long run . . . most of the costs will be passed backward to the owners of land" (Mallach 1984, 88).

A strong argument in support of this position is that a rational developer will already charge the maximum housing sale price that the market can bear, and thus will be unable to pass along additional costs through higher prices. Under those

circumstances, if newly imposed exactions increase the cost of development, either the price of the land or the developers' profits will have to come down. While developers may reduce their profit margins, it is likely that wherever possible they will seek a reduction in land costs. Critics of IH maintain that these represent unreasonable and unfair outcomes, while proponents argue that it is neither unfair nor unreasonable for the landowner to bear much of the cost of inclusionary programs.

Is the reduction of land costs a desirable outcome of IH? Put differently, does the imposition of IH actually reduce land value from some level intrinsic to the land, or does it represent the recapture of an increment in land value associated with governmental action?

It is widely argued that increases in land values do not generally result from the owner's unaided efforts, but rather from public investments and government decisions, and are therefore in whole or part "unearned." This argument is accepted in many European countries, leading to the adoption of regulations that attempt to recapture or eliminate what are considered to be windfall profits associated with land development. Our research, supported by the Lincoln Institute, has found that in many countries IH is viewed explicitly as a

mechanism to recapture unearned increments in land value.

In the United States, where the “right to develop” is far more central to the concept of property rights than is the case in most European countries, land value recapture is not widely recognized as a part of planning practice and land development. Thus, the imposition of affordable housing obligations is often legitimized by providing compensation in the form of incentives or cost offsets to developers for the additional costs of providing IH.

As Hagman (1982) has argued, incentives such as density bonuses and other cost offsets have no effect on the price paid by the buyers of market units, but ensure instead that the unearned increments in land value will keep flowing to landowners. Even housing advocates will argue for cost offsets, if only as a way of gaining support and blunting developers’ opposition to the enactment of inclusionary ordinances. Incentives and cost offsets provided to developers are not free, however, but may carry potentially high public costs.

Incentives and Cost Offsets

It has been argued in the United States that without incentives and cost offsets, “inclusionary housing becomes a constraint or an exaction on new

development” (Coyle 1991, 27–28). For example, the California Department of Housing and Community Development (HCD) has advised for years against “the adoption by local governments of inclusionary housing ordinances or policies which shift the burden of subsidizing low-income affordability from government to private builders” (Coyle 1994, 2). The current HCD position is that IH creates a potential obstacle to private residential development and therefore localities must demonstrate that IH adoption or implementation has a neutral or even positive impact on development. Similarly, a 2007 New Jersey court decision found that municipalities seeking to enact inclusionary ordinances must provide the developers with “compensating benefits” to mitigate the cost of the affordable housing obligation (*In the Matter of the Adoption of N.J.A.C. 5:94 and 5:95*, 390 N.J. Super. 1 (App. Div, 2007), certif. denied 192 N.J. 72 (2007).

In this climate, it is understandable that local governments incorporate cost offsets or incentives in their inclusionary programs, even in the absence of a clear legal doctrine requiring offsetting benefits. These programs may include density increases or “bonuses,” waivers or deferral of impact fees, fast-track permitting, lower parking requirements,

Mill River House is a 92-unit mid-rise in a downtown redevelopment area of Stamford, Connecticut, with a 12 percent low/moderate income set aside.



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relaxation of design standards such as street widths and setbacks, or other regulatory concessions that subsequently reduce developers' costs. In addition, financial incentives may be provided through federal Community Development Block Grants and Home funds or state and local subsidies, including below-market-rate construction loans, tax-exempt bond mortgage financing, and land write-downs.

A survey of IH in California found that local financial subsidies are common among the most productive jurisdictions (NPH/CCRH 2007). The most frequently used subsidy is tax increment financing (TIF), which is all but synonymous with redevelopment in California. Under state law, 20 percent of all TIF revenues must be dedicated to the provision of affordable housing. After TIF funds the most widely used incentives are density bonuses and permit-related concessions, such as deferral, reduction, or waiver of applicable permit and impact fees. Some jurisdictions also offer fast-track processing and flexibility of design standards, including height and bulk requirements, as well as parking and open space requirements. In his national study of IH programs, Porter (2004, 9) found a similar pattern with "the most common compensatory offering being density bonuses . . . although their specific value in any given location is difficult to calculate."

Studies have shown that it is often possible to fill the affordability gap—the difference between what it costs to provide housing and what lower-income households can afford—through local government measures that reduce production costs. However, developers often argue that cost offsets alone do not compensate them adequately for inclusionary requirements. Even additional financial assistance does not guarantee acceptance of IH by the development industry. In large jurisdictions in fast-growing areas with powerful development interests, even cost offset approaches can be thwarted, particularly during recessionary periods, as they were most egregiously in the City of San Diego in the early 1990s (Calavita and Grimes 1994).

These incentives often come at a public cost. Financial incentives are paid directly by taxpayers, either through appropriations at the federal, state, or local level, or by redirecting revenues that would otherwise go into the city's general fund. The effect of fee waivers, reductions, or deferrals is nearly as direct. Development creates demands for public facilities, services, and infrastructure, the costs of



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which are typically mitigated by fees whose nature and amount is directly related and roughly proportional to the development's impact.

When a project does not pay its full cost, the city must make up the lost revenue or allow infrastructure or service levels to decline. In either case, the public bears a cost. Fast-track permit approval will require more personnel to process the plan at public cost, or lengthen delays for projects that do not benefit from the fast track. Lower parking requirements might be justified by the assumption that lower-priced units require less parking, an assumption that may not be supportable in all cases, and thus a legitimate cause of concern for neighborhood groups.

Density bonuses, which are used widely to incentivize urban design amenities as well as affordable housing, can be both the most attractive to the developers and the most problematic to the public at large. When superimposed on an existing planning framework, density bonuses raise three major areas of concern.

1. They undermine existing regulations, effectively undoing land use planning and zoning regulations without the associated processes that usually accompany zoning changes. A Los Angeles

Torrey Highlands, a 76-unit IH project serving families earning up to 60 percent of area median income, is in the City of San Diego's northern fringe area.

SOMA Grand is a 246-unit condominium project with 29 IH units in the South of Market (SOMA) neighborhood of San Francisco. The IH units are affordable to families making 100 percent of area median income, while the market-rate units sell for between \$500,000 and \$1.9 million.

- City Council member opposed to IH stated: “This proposal automatically increases a density in a community by 15 percent, which in effect trashes a community’s efforts to master plan their community” (Smith 2004, 2).
2. They may lower the level of service of public facilities and infrastructure in the area. Analysis of the adequacy of public facilities, identification of needed improvements, and scheduling of the investments—either on the part of the developer or the locality—is needed to ensure that levels of service will not deteriorate as a result of the additional density associated with land use or zoning changes. Without it the quality of life and public services in neighborhoods affected by significant use of density bonuses may deteriorate. These impacts are rarely taken into consideration.
 3. They frustrate citizen participation in the planning process by being enacted outside of that process. Once approved, their implementation is piecemeal, and their impacts only gradually felt.

A critical distinction must be made, therefore, between density increases resulting from an up-zoning based on a planning process that has presumably taken into account the issues arising from an increase in land use intensity, and density bonuses superimposed on existing zoning with the potential to have a significant but unanticipated impact on neighborhoods. The costs imposed by density bonuses, as with other incentives, are often forgotten by those who propose using cost offsets and incentives to support IH.

Land Value Recapture Through Rezoning

Reliance on cost offsets and incentives implicitly assumes a static view of urban planning—that IH requirements will be applied within the existing planning and zoning framework as part of the subdivision or site plan approval process. Within this framework, while rational developers will try to buy the land at prices that reflect those requirements, the availability of cost offsets will reduce the developer’s motivation to bargain with the landowner who, in any case, will not be motivated to sell her land at any less than the price she could get in the absence of IH requirements. In the end, the landowner is likely to get her price and the developer his profits, while the city and the neighborhoods absorb the costs. All of this reflects the re-



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luctance of the public sector in the United States to confront the effects of any action on land values. There is a better way.

Planning is a dynamic process. Plans and ordinances are changed constantly to reflect both changes in external conditions and the potential profit to be made from upzoning properties to higher density or more profitable uses. Constant zoning changes are a reality of the planning process in any area with strong development demand. When land use intensities change and land values increase as the result of public action, IH can become an integral part of the local land use planning and development process, rather than being superimposed on a pre-existing framework. Thus, IH can become an instrument to recapture the land value increment associated with the government action of rezoning or land use changes.

The state of Washington took a step in this direction in 2006 in enacting HB 2984, which specifically authorizes IH where it is linked to upzonings. As described in one commentary, “If a city decides to upzone a neighborhood, it can require that anyone building in that area include a certain number of affordable units. . . . The justification of this requirement is that the property owner has

been given increased land value by virtue of the upzone, and that increased value is the equivalent of an incentive under a voluntary program” (The Housing Partnership 2007, 5).

Rules proposed by the New Jersey Council on Affordable Housing, which sets standards for IH in the framework of the state’s statutory fair-share scheme, have moved in a similar direction. The rules establish “minimum presumptive densities” and “presumptive maximum” IH set-asides, ranging from 22 units to the acre with a 20 percent set-aside in urban centers to 4 units to the acre with a 25 percent set-aside in areas indicated for lower density under the State Development and Redevelopment Plan (New Jersey Council on Affordable Housing 2008, 47–48). Although not explicitly linking the inclusionary requirement to a rezoning per se, rezoning will be needed in many, if not most, cases to achieve the presumptive densities required by the proposed rules.

Recent New Jersey legislation has gone a step further, mandating that every residential development “resulting from a zoning change made to a previously nonresidentially zoned property, where the change in zoning precedes the application . . . by no more than 24 months,” contain a set-aside of housing affordable to low- and moderate-income households (Public Law 46 of 2008, amending N.J. Statutes Ann. 52:27D–307). The Council is empowered to set the appropriate set-aside percentage in such cases based on “economic feasibility with consideration for the proposed density of development.” Although the concept is arguably implicit in the Washington statute, the New Jersey legislation appears to be the first time that the principle of “planning gain,” as it is termed in the United Kingdom, or the recapture of the land value increment resulting from rezoning for the benefit of affordable housing, has been enshrined in American land planning law.

We are not proposing that communities do away with existing IH systems, but rather that there be a two-tiered approach. The first would impose modest inclusionary requirements within an existing zoning framework, incorporating those incentives that can be offered without undue cost to the public. The second would be associated with significant upzonings of either specific parcels or larger areas grounded in the principle of land value recapture, imposing inclusionary requirements that in many cases could be substantially higher than the 10 to

20 percent range that is now customary. A period of transition might be appropriate to allow land markets to adjust to the new regulatory framework.

In conclusion, the time has come to reconsider the underlying premises of IH in the United States. By grounding IH in the practice of rezoning, we believe it is possible to better integrate inclusionary housing into good planning practices and begin to recapture for the public good some part of the unearned increment in land values resulting from the exercise of public land use regulatory powers. **L**

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