## Economic Impact of Inclusionary Housing

Over the last year, a significant amount of discussion has revolved around the cost associated with adopting an inclusionary housing program. Two primary threads of this discussion have evolved; how much does it cost and who should pay.

In the discussion of how much it costs, there is one element on which all parties can agree: that the economic impact of any inclusionary program is very difficult to quantify. Prior to being able to identify the impact to a development, two basic figures must be known - how much does construction cost and what type of return should be due a developer after completion. These figures will vary from project to project based on a variety of factors that are unique to each development. These factors could include land cost, construction costs, site size and constraints, market conditions, community concerns, among many other direct and indirect factors. Further contributing to the difficulty of determining these numbers is that many of these factors are dynamic, changing from one moment to the next and from one project to the next.

Once it is acknowledged that it is infeasible to establish the costs associated with every new development, one must attempt to identify a methodology that could satisfy the majority of development scenarios. Differentiations among developments could be made based on geographic location, construction type, market conditions, whether the product is produced as a rental or for-sale unit or a variety of other conditions affecting the cost and marketability of a project.

One formal attempt to produce development costs has been made by Keyser Marston Associates Inc. (KMA). KMA was retained to act as a financial consultant for the discussions in the Inclusionary Housing Working Group. KMA, an expert in economic analysis, was tasked with determining the financial implications of an inclusionary set-aside and, further, determining the financial significance of potential benefits or incentives available to add economic benefit to developments.

In attempting to quantify the financial impact on new residential development, the IHWG determined six development types or prototypes that would most likely be developed in the City over the next twenty years. In making recommendations, a variety of factors were considered, including current and future land supply, constraints on new construction, current and future zoning, including allowable densities, and demand from the market. The prototypes also took into account the great geographic and economic distinctions found throughout the City. The resulting prototypes were meant to represent average models of new development for the City of San Diego over the next twenty years.

Once the prototypes were established, KMA performed in-depth analysis on the cost associated with developing each prototype. This included a thorough pro forma for each prototype, including land cost, construction cost, applicable permits and fees, financing costs and developer/builder returns. During the process, the base case pro formas were taken to the development community to confirm the assumptions that had been used. Despite the inclusive nature of the analysis, there has still been a variety of criticism for the resulting figures.

One area of significant debate has been how the market absorbs the requirements imposed under a new inclusionary program. There are several camps of thinking. One camp has espoused the viewpoint that a substantial portion of the cost of new regulation, fees or taxes on development is absorbed over time in the cost of land. The basis for this perspective is that as developers evaluate the feasibility of a new project, they will accommodate the added cost of fees as they determine residual expenses, the largest of which is land cost. Patient land sellers could wait for more favorable market conditions.

Another camp believes that the full cost of the inclusionary requirement will be passed to the market-rate renter or homebuyer, thereby further driving up the cost of the market. However, some counter that "the market is what the market is." In other words, price is only elastic up to a point and may not absorb the entire gap.

A third and most pragmatic viewpoint states that the costs are shared. This camp references the work of researchers that assert that the costs of inclusionary housing will be distributed among three parties: the developer, the landowner who sells property to the developer, and the homebuyer or renter of market rate units. The extent to which each party will participate will depend on local market conditions. For example, in the event that the end market-rate consumers are unwilling or unable to fully absorb higher prices, developers would reduce their profit margin. In cases where a developer does not own the land at the time an inclusionary housing program is enacted, he would negotiate a lower price with the owner of the land. In most cases, the market will disperse the cost over all three areas, making the impacts to each modest.

ECONOMIC IMPACT OFFSETS

This debate over economic impact yields the most significant area of divergence among the proposals. It is the degree to which the proposed incentives and subsidy packages provided by the local government should be expected to offset any financial impacts imposed by program requirements. Some propose that the City should share or absorb any cost burden born by the development industry, while others feel that market factors and/or potential incentives can provide a sufficient accommodation in exchange for development rights.

To the extent to which there is an economic impact to the developer, there are a range of opinions concerning the level and need for tools to offset any cost associated with an inclusionary housing program. Due to the difficulty in assessing the actual impact on developers and the potential for external factors to mitigate costs, there is reluctance on the part of some to provide financial subsidy to the developer.

In the event that subsidy or incentives are used in association with an inclusionary housing program, there is a wide range of options available. A menu of potential incentives can be found as Attachment 3 with the economic value of several incentives assessed in Attachments 5, 6, and 7. A menu of potential revenue sources for subsidy can be found as Attachment 4.

**ATTACHMENT 2**

## ADDRESSING SHORT TERM MARKET CONCERNS

An additional concern that the development industry has frequently expressed is that the added cost of development imposed by the inclusionary requirement would drive many developers from the market, thus slowing down all new residential construction. Certainly, in a market, with a critical under-supply of housing, this is a significant concern.

It is believed that if there is an impact to the market, it will be a short-term impact during the time the market is adjusting to any new cost. There are two ways that have been identified to address these concerns.

The first way would be to phase program requirements in over a period of time in order allow developers that have already purchased land or have land under contract to avoid unanticipated costs imposed by the program. A second alternative would be to provide a fixed developer subsidy during the initial adjustment period that would be phased out over a number of years. A drawback to both of these approaches could be a slowing in the time period in which the market would adjust. Economists estimate that market adjustments can take place over the time of a typical development cycle.

In the recommended program, the requirements are phased-in over a three-year period in order for the market to adapt to the new regulations. This is accomplished by allowing a nominal fee to be paid by the developer in the first year in lieu of constructing affordable units. In the second year, this fee is increased to a moderate level. By the third year, the fee is further increased to an amount that is sufficient to subsidize the construction of affordable units through the non-profit and public sectors.