Increasing Inclusionary Housing Requirements: Economic Impact Report

Office of Economic Analysis

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Introduction

- New housing projects with more than 10 units are currently required to pay an Inclusionary Housing Fee to fund affordable housing.
- The fee may be paid through the provision of affordable housing units on-site, off-site, or by paying a fee in-lieu of directly producing the housing, at the option of the developer.
- At present, these inclusionary requirements are defined in the City Charter. The proposed Charter amendment, which must be approved by the voters, would establish interim affordable housing requirements that are higher than those currently in the Charter. In addition, it would allow future changes to the requirements to be made by the Mayor and the Board of Supervisors, without voter approval.
- The legislation would apply to all projects that have not received a first discretionary development entitlement approval, and have not entered a development agreement with the city.
- The Office of Economic Analysis (OEA) has prepared this report because it has determined the interim requirements it imposes might have a material impact on the city's economy if they was enacted.

Economic Impact Factors

- The proposed legislation is likely to create both benefits and costs to the local economy. Increasing investment in affordable housing will tend to make housing more affordable, particularly for low-income households, who currently spend half of their income on housing.
- On the other hand, increasing affordable housing requirements will raise the cost of developing market-rate housing. This may lead to a slowdown in the development of market-rate housing, which would constrain supply and place upward pressure on housing prices.
- Assessing the net impact–the legislation's overall impact on housing affordability in San Francisco—therefore involves estimating if the benefits of increased funding for affordable housing outweigh the cost of reduced market-rate housing development.

Impacts of Discouraging Market-Rate Housing

- Policy changes that make market-rate housing projects infeasible raise the value of existing housing, by reducing the number of houses on the market at any point in time.
- Previous OEA research has suggested that a policy change that resulting in loss of 1,000 units of market-rate housing would lead to a 0.3% increase in housing prices across the city.

Impacts of Investing in Affordable Housing

- Permanently-affordable housing for low- and middle-income households creates two kinds of benefits.
- First, households that live in the affordable units get a direct subsidy, because their housing payment is set to 33% of their income.
  - For San Francisco households at 80% of AMI or below, who now spend an average of 50% of their income on housing, this subsidy would feel like a 34% price reduction, based on their current average housing payments in the private market (according to Census data).
  - For households at 120% or below, who spend closer to 40% of their income on housing, the subsidy would be worth less: equivalent to a 15% price reduction.
- Households with similar incomes that do not live in the affordable unit get an indirect benefit, because the new housing leads to fewer households competing with them in the private market.
  - For low-income households, the indirect price benefit of 1,000 units of affordable housing is a 0.8% reduction in their housing prices.
  - For low- and middle-income households, at 120% of AMI or below, the indirect benefit is a 0.6% reduction.

Impact of the Proposed Legislation on the Cost of Development

- At present, market-rate developers may meet their affordable housing requirement by providing 12% onsite, 20% offsite, or paying an in-lieu fee at a 20% rate. Higher requirements may apply in some areas of the city.
- The proposed legislation would raise these requirements for projects having 25 units or more. Projects with fewer than 25 units would be unaffected.
  - for developers selecting the fee option, the fee would be raised from 20% to 33% - a 65% increase. Given the current fee levels, developers electing this option would face an average fee increase of about $40,000 - $45,000 per unit, or about 4% of the average sales price of a new unit.
  - for the on-site option, at present, 12% of units must be affordable to households earning 90% of Area Median Income (AMI) or less, among other requirements. The proposed legislation would require that 15% of units be affordable to households earning 80% of AMI, and an additional 10% be affordable to households earning 120% of AMI or less. The OEA estimates the additional cost of the on-site option to be slightly more than the additional cost of the fee option, about 5% of sales price.
  - for the off-site option, at present, 20% of units must be affordable to households earning 90% of AMI or less. The proposed legislation would require the 20% to be affordable to 80% of AMI or below, and require an additional 13% to be affordable to households earning 120% of AMI or less. The OEA also estimates the additional cost of the off-option to be comparable to the additional cost of the fee option, about 4% of sales price.

Fee Increases and Market-Rate Housing Production

- Economists generally believe that when production costs increases, some of the cost is eventually passed on to consumers in the form of higher prices. While a housing developer cannot generally raise the sales prices or rents of their own new units to make the customer pay a fee increase directly, a fee increase will reduce what a developer can afford to bid for development sites, and slow the overall pace of housing construction. The resulting contraction in housing supply will tend to drive up housing prices, so that all home-seekers, and not just the purchasers of new units, ultimately pay the higher fees.
- On the other hand, housing development in San Francisco is sometimes held to be relatively unaffected by fee increases, because of the strong demand for housing in the city, and because changes in zoning make housing development profitable on many parcels, even with relatively high fees. According to this view, higher fees may reduce the value of land, but not enough to significantly discourage new housing construction.
- To empirically assess the impact of rising fees on housing construction, the OEA worked with data on housing construction in the city over the 2001-2013 period, and estimated which site, zoning, and market characteristics explained why a given parcel added new housing during that period.
- We then used those results to simulate how much housing might be built over the next twenty years, both with and without the proposed fee increase. The model is discussed in greater detail on the next page.

Details of the Simulation Model

- The model was built from the following data sets:
  - a database of land parcels in San Francisco, including each parcel's area, zoning, maximum allowable heights, and other site information was provided by the Planning Department.
  - a housing price index developed by the OEA based on CoreLogic property transaction data. This index is specific to San Francisco and closely tracks other such indices, such as Zillow's.
  - a list of market-rate housing developments in the city from 2001 to 2013, prepared from the Planning Department's annual Housing Inventory reports.
  - an estimate of existing development, by type of land use.
- The data was used to estimate which zoning, structural, and market factors statistically explain whether each parcel in the city added new housing over the 2001-2013 period.
- The results were used to create a baseline housing projection for the next 20 years. The projection was then re-run using to reflect the costs of accommodating the higher proposed requirements. The difference between the two projections is our estimate of the market-rate housing that would not be developed as a result of the legislation.

Results of the Development Modelling

- The analysis of which parcels in the city added housing over the 2001-2013 period indicate that important variables include:
  - Height limits –parcels where the height limits are significantly higher than existing structures are more likely to see new development.
  - Zoning – parcels zoned for high-density residential development, or without density controls, are more likely to be developed.
  - Current land use – parcels currently used for production, distribution, and repair activities, or having historic resources, are less likely to be developed.
  - Housing prices – all other things being equal, a parcel is more likely to be developed when prices are high.
- These model results were used in a series of simulation models that estimated the likely number of new market-rate housing units built in the city over the next 20 years, with and without the proposed policy change.

Impacts on Affordable Housing Funding and Affordability

- The fiscal impacts of any tax or fee increase always reflect both the revenue gains associated with the higher rate, and the revenue losses associated with discouraging the activity that is being assessed. The net impact depends on how sensitive the activity is to higher costs of production.
- In this case, to consider just the new in-lieu fee option, which our analysis suggests would be the lowest-cost alternative for developers, the proposed rate will increase 65%. Overall housing development is projected to decline by 11% for developers taking the fee or off-site option, or 13% for the on-site option.
- Accordingly, in lieu fee revenue is projected to grow. A similar situation is expected to occur with on-site and off-site affordable units – the rate at which they will be produced increases a great deal, while the number of projects producing them decreases by less.
- However, resources for affordable housing is not the only relevant metric of housing affordability. The loss of market-rate housing harms affordability for all income groups – especially those for which no affordable housing subsidy is provided.
- The tables on the next three pages indicate how housing prices are projected to change for low-income households specifically, and for the city overall.

Potential Impact on Affordability: On-Site Option

- Actual housing production trends are difficult to predict, as they depend on future housing prices. For this reason, we modeled the costs and benefits of the proposed legislation for every 1,000 market rate units that would have been built under current law, and then calculate net impacts on affordability for different income groups, for the on-site, off-site, and fee options.
- The illustration below shows that 1,000 new units would, under current legislation, be required to include 120 affordable (BMR) units. Under the proposed legislation, the number of market-rate units would fall by 231, but the number of affordable units would rise. As shown below, the net effect would be somewhat lower housing prices for low-income households, and although higher prices overall.

	Total Units	Market Rate	On-site units @ 12%, 90% AMI	On-site units @ 15%, 80% AMI	On-site units @ 10%, 120% AMI	Total BMR
Without proposed legislation	1,000	880	120			120
With proposed legislation	865	649		130	86	216
BMR unit gain	96					
Market-rate unit loss	231					
Net impact on housing prices, 80% AMI	0.002%	decrease				
Net impact on citywide housing prices	0.040%	increase				

Potential Impact on Affordability: Off-Site Option

- Similarly, for developers who would choose the off-site option, an 11% reduction in housing would lead to a 25% decline in the number of market-rate housing units constructed, but close to a 50% increase in the number of affordable units.
- The net impact is a housing price reduction for low-income households, and an increase in housing prices across all income groups.

	Market-Rate Housing	Market Rate	Off-site units @ 20%, 90% AMI	Off-site units @ 20%, 80% AMI	Off-site units @ 13%, 120% AMI	Total BMR
Without proposed legislation	1,000	800	200			200
With proposed legislation	885	593		177	115	292
BMR gain	92					
Market-rate loss	207					
Net impact on housing prices, 80% AMI	0.01%	decrease				
Net impact on citywide housing prices	0.03%	increase				

Potential Impact on Affordability: Fee Option

- For the fee option, we cannot directly compare the creation of affordable and market rate units. Instead, we estimate the in-lieu fee revenue that would be raised from a higher fee, and compare that to the market-rate units lost.
- An 11% reduction in market-rate housing is projected to lead to close to a one-third increase in affordable housing fee revenue, with a revenue-per-unit lost ratio of $270,000.

	Market-Rate Housing	Average fee per unit	Fee Revenue, 2016-35 ($M)
Without proposed legislation	1,000	$68,310	$68
With proposed legislation	885	$112,712	$100
In-Lieu Fee revenue gain	$31		
Market-rate unit loss	115		
fee revenue per unit lost	$272,212		

Caveats and Cautions

- The model discussed in this report has a number of limitations, which largely stem from the fact it was developed in response to legislation introduced five weeks prior to the report's release. These limitations lead us to apply an unusual level of caution to the conclusions we draw from our analysis.
- First, the underlying data is subject to a variety of errors, particularly the data on the existing uses on each parcel, which is an important determinant of whether the parcel will redevelop as housing. In addition, the data on housing construction covers a relatively short 13 year period. It is possible that additional research could produce higher-quality data, covering a longer period of time.
- Secondly, the model itself could be refined in a variety of ways that would probably improve its predictive power, and the reliability of its results. Currently, the model does not take into account that many development sites covered by the legislation are already required to build more than what the law generally requires. This limitation in the model tends to over-state the benefits of the proposed legislation.
- The model also does not distinguish between ownership and rental properties. Rental properties tend to have a far lower sale price than condominiums, and changes to the fee option, in particular, could have a more discouraging effect on rental housing production than the model currently recognizes.

The Cost of Uncertainty

- The proposed legislation removes the inclusionary requirement from the City Charter, which can only be changed by the voters. The impact of making it easier to change the requirement, through the normal legislative process, could be significant.
- Although the proposed interim changes "grandfather" projects that have already received entitlements, thus protecting some developers from an unexpected increase in their requirements, the possibility of future increases could lead developers to reduce their bids for properties to insure themselves. This could limit the sale of potential housing sites to developers.
- Should developers behave in this way, it would further slow the pace of market-rate housing without providing any affordable housing benefits. Developer uncertainty itself would raise housing prices, at all income levels.
- The City can minimize this risk by taking a deliberate, well-researched approach to future changes to the inclusionary requirements, that leads to a maximum of confidence among all stakeholders that an optimal decision has been reached. In this way, future ad hoc changes may be avoided, and the cost of uncertainty can be reduced.

Conclusions

- Raising the cost of development would normally result in the market producing less housing, as marginal projects become financially infeasible. However, this analysis suggests this is unlikely to happen in San Francisco to a great degree as a result of the proposed increase, and the reasons why are worth exploring.
- A main reason is that, as a result of the city's zoning policies, there are relatively few marginally-feasible housing projects to begin with. Housing prices are less important than land use controls in explaining whether a parcel will develop new housing over the next twenty years.
- As a consequence, this analysis suggests that the City may well be able to expand its affordable housing resources in ways that improve housing affordability for low- and middle-income households, despite some loss of market-rate housing construction.
- However, this analysis hinges on data that is imperfect, and a modeling approach that could be further refined. The benefits of future changes to the inclusionary requirements could be enhanced by better data and a more refined feasibility study.

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