



Inclusionary Zoning



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A Framework for Assessing the Advantages and Disadvantages

changing policy
to bring working families home

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Inclusionary Zoning: A Framework for Assessing the Advantages and Disadvantages

Prepared for
Homes for Working Families

by Dustin C. Read, J.D., Associate Director, The Center for Real Estate at UNC Charlotte

In collaboration with
the Center for Metropolitan Studies



I. INTRODUCTION

Inclusionary zoning ordinances encourage or require real estate developers to set aside a percentage of the units included in market rate residential development projects for low and moderate income households.¹ By leveraging the resources of the private sector, this type of land use regulation potentially offers an effective way to expand the housing options available throughout a jurisdiction without the need for costly public subsidies.² However, concerns have also been raised that inclusionary zoning can have a detrimental effect on local housing markets in various economic environments. The following analysis, funded by Homes for Working Families and completed by the Metropolitan Studies Group and the Center for Real Estate at UNC Charlotte, addresses these issues by examining the potential advantages and disadvantages of inclusionary zoning.

The study begins by describing the structure of inclusionary zoning ordinances, and explaining how they differ from other affordable housing initiatives. Existing economic literature is reviewed to consider whether inclusionary zoning encourages the production of affordable housing by providing real estate developers with appropriate economic incentives or by shifting the cost of affordable housing to other market participants, such as landowners and market rate homebuyers. The analysis concludes by discussing best practices implemented in urban areas throughout the United States to ensure inclusionary zoning has the greatest impact on housing affordability. Each phase of the analysis is designed to provide a value neutral assessment of inclusionary zoning and its potential effectiveness in different types of housing markets.

II. THE STRUCTURE OF INCLUSIONARY ZONING ORDINANCES

Inclusionary zoning ordinances are often described as the antithesis of “exclusionary” land use regulations, such as minimum lot size requirements and restrictions on multifamily construction, which have contributed to the shortage of affordable housing in the United States.³ The description is elegant, but somewhat inaccurate. Inclusionary zoning ordinances do not directly

reduce the number of regulations imposed on all types of residential development. Many of these ordinances actually put additional administrative procedures in place to ensure real estate developers construct housing for a specific segment of the market. Therefore, inclusionary zoning must be differentiated from other steps taken by state and local governments to remove regulatory barriers preventing the development of affordable housing.

Removing Regulatory Barriers

A municipality with an overly restrictive zoning ordinance in place can potentially increase its stock of affordable housing by relaxing the regulatory requirements governing residential development. Some communities have done this by expanding the amount of land zoned for multifamily construction or by authorizing higher density development.⁴ These approaches do not guarantee the development of housing accessible to low and moderate income families, but they may relieve pressure on prices throughout a market by removing artificial constraints on supply.

Many local governments, however, have found it advantageous to leave exclusionary zoning ordinances in place to address a variety of fiscal and social externalities.⁵ Low and moderate income housing may fail to “pay for itself” because it generates a limited amount of property tax revenue and attracts residents with relatively high public service demands.⁶ All types of

¹ Harmon (2004).

² Burchell and Galley (2000) cite the low cost of inclusionary zoning to the public sector as one of the most important benefits offered by this type of affordable housing program.

³ West (2005) describes inclusionary zoning as the “mirror image” of exclusionary housing policies, while inclusionary zoning is described as a “response to exclusionary land use practices” by Kautz (2002). The relationship between land use regulations and housing affordability has been studied for over forty years. See Quigley and Rosenthal (2005) and HUD (2004).

⁴ Tustian (2000) notes that the City of Portland has increased density allowances inside its urban growth boundary in an attempt to encourage more affordable housing development, although it does not require developers to set aside units for low and moderate income households.

⁵ Stockman (1992).

⁶ Ladd (1992) concludes that residential development often results in a fiscal shortfall for municipal governments. The conclusion is generally accepted by the planning community, although a number of studies funded by the development

residential development can also generate negative externalities such as traffic congestion, loss of green space, and overcrowded public schools. These factors create economic and political incentives for local planning officials to restrict the amount of land available for new housing.⁷

Land use regulations limiting housing supply can put upward pressure on prices, but they are not necessarily inefficient from an economic perspective if they restrict development to a socially optimal level reflecting the cost of fiscal and social externalities. However, imperfect market information may prevent public officials from accurately balancing a community's need for affordable housing against other benefits obtained from controlling growth such as reduced congestion and preservation of public infrastructure.⁸ Some scholars have additionally expressed concern that local officials enact land use regulations for political reasons with little regard for economic efficiency.⁹ A few states have intervened in these situations by enacting "anti-snob" statutes.

Anti-Snob Statutes

Anti-snob statutes are enacted at the state level and provide real estate developers with a way to compel municipal governments to accommodate the construction of affordable housing. The approach is sometimes referred to as a form of voluntary inclusionary zoning, although it is distinctively different from the type of inclusionary zoning enacted by municipal governments.¹⁰ Massachusetts was the first state in the country to implement an anti-snob statute by creating a consolidated permitting process for development projects, including affordable housing.¹¹ If local officials decide not to issue a comprehensive permit for an eligible project, the developer can appeal the decision to the State Housing Appeals Committee. The municipality denying the

⁷ Powell and Stringham (2004) note that the practice of adopting land use regulations to preserve a community's tax base is sometimes referred to as the "fiscalization of land use".

⁸ Fenster (2006) states that estimating the impact of negative externalities generated by various land uses can amount to guesswork due to imperfect information.

⁹ Schill (2005) suggests land use regulations are often used to shift the financial burden of providing public services rather than to increase economic efficiency in the real estate market.

¹⁰ Dietderich (1996).

¹¹ Stockman (1992) describes Massachusetts's anti-snob legislation and notes that similar statutes have also been enacted in Connecticut and New Hampshire.

permit must then demonstrate that there is a legitimate reason for the decision that outweighs the jurisdiction's need for affordable housing.

An anti-snob statute's effectiveness is predicated on two assumptions: (1) regulatory barriers or community opposition are the primary factors limiting the availability of affordable housing and (2) real estate developers are willing and financially able to produce affordable housing in the absence of exclusionary land use regulations. These assumptions are potentially appropriate in heavily regulated markets, but may fail to capture the importance of other economic factors. Strong market demand has increased housing prices and limited the options available to economically disadvantaged residents in many parts of the country. Anti-snob statutes are generally ineffective in these markets because they do not provide the private sector with a financial incentive to produce affordable housing.¹² Inclusionary zoning ordinances can offer better solutions in these situations.

Inclusionary Zoning Ordinances

Inclusionary zoning ordinances are structured in a number of different ways, but can generally be described as land use regulations enacted by municipal governments to encourage the development of mixed-income housing. The approach is potentially beneficial because it focuses on reducing concentrated poverty and providing economically disadvantaged residents with better access to employment by integrating affordable housing units into market rate development projects located throughout a community. Inclusionary zoning does, however, rely on ongoing development activity and may be ineffective in weak markets or in jurisdictions with little land available for new construction.

Three types of inclusionary zoning ordinances are enacted at the local level.¹³ Mandatory inclusionary zoning ordinances require real estate developers to set aside a percentage of the units included in market rate residential development projects for low and moderate income households. Voluntary inclusionary zoning ordinances, on the other hand, attempt to entice the private sector to construct mixed-income housing by offering economic incentives. Conditional

¹² Cowan (2006) and Witten (2003). Witten criticizes anti-snob statutes as a reactionary approach to affordable housing because it does not require local officials to consider a community's long term housing needs.

¹³ Schofield and Brown-Graham (2004) provide an overview of the three types of inclusionary zoning .

inclusionary zoning ordinances do not technically require the private sector to construct mixed-income housing, although regulatory approvals are not issued for new development unless affordable units are included in a project. Each of these types of inclusionary zoning share several common characteristics, including: set-aside requirements, income targets, economic incentives, and mechanisms to ensure units remain affordable for an extended period of time.¹⁴

Set-Aside Requirements

Set-aside requirements dictate the number of rental or owner-occupied units that must be reserved for low or moderate income households pursuant to an inclusionary zoning ordinance. Often expressed as a percentage of the total number of housing units included in a project, the average set-aside requirement in the United States is approximately 15%, ranging from 5% to 35% across jurisdictions.¹⁵ Some inclusionary zoning ordinances have different set-aside requirements for rental and owner-occupied development projects, as well as separate set-aside requirements for each income group targeted by the ordinance.¹⁶ A conditional inclusionary zoning ordinance may allow real estate developers and local planning officials to negotiate set-aside requirements on a case-by-case basis.

Income Targets

Affordable units included in mixed-income projects must be accessible to households within a targeted income range, usually defined in terms of area median income (AMI). Ordinances designed to serve low-income households often focus on those earning less than 60% of AMI, while ordinances serving moderate and middle-income households may include those earning up to 200% of AMI. Housing units set aside for these income groups are generally priced at a level

¹⁴ Mandatory inclusionary zoning ordinances also include a few additional provisions that are discussed in a subsequent section of this analysis.

¹⁵ Calavita et al. (2004). The set-aside estimates are based on a survey of over one hundred municipalities with inclusionary zoning ordinances in California.

¹⁶ Tustian (2000). An inclusionary zoning ordinance in Montgomery County Maryland has a mandatory set-aside requirement and then offers additional economic incentives to developers if they choose to set aside more units than are required.

requiring a household to spend no more than 30% of its gross income on rent or mortgage payments.¹⁷

Economic Incentives

Local governments enacting inclusionary zoning ordinances generally provide the private sector with a variety of economic incentives to offset some or all of the cost of developing affordable housing. These incentives are essential to encourage participation in voluntary programs, although most mandatory and conditional programs also offer incentives to prevent real estate developers from relocating to other markets in search of a more favorable regulatory environment.¹⁸ Economic incentives may include density bonuses, expedited project review, fee waivers, alternative design standards, direct cash subsidies, and tax abatements. The following table provides an overview of these economic incentives.

Table 1. Economic Incentives Offered by Inclusionary Zoning Ordinances		
	<i>Public Sector Advantages</i>	<i>Public Sector Disadvantages</i>
Density Bonuses	-Minimal Direct Cost -Increases Housing Supply -Encourages Compact Development	-Less Valuable in Weak Markets -Increases Demand for Public Infrastructure
Expedited Permitting	-Minimal Direct Cost -Reduces Private Sector Risk Exposure -Increases Housing Supply	-Limited Value in Markets with Few Regulatory Barriers
Fee Waivers	-Valuable in Markets with Exactions -Politically Attractive	-Reduces Public Sector Revenue -Limited Value in Markets with Minimal Development Fees
Alt. Design Standards	-Minimal Direct Cost -Increases Private Sector Flexibility	-May Reduce Housing Quality -Market Forces May Require Higher Design Standards
Cash Subsidies	-Efficient and Easy to Administer -Preferred by Developers	-High Direct Cost -Requires Funding Source -Political Opposition
Property Tax Abatement	-Efficient and Easy to Administer -Cost Spread Over Multiple Years	-Reduces Public Sector Revenue -May diminish Infrastructure Quality

¹⁷ Income requirements often conform to the Department of Housing and Urban Developments definition of housing affordability.

¹⁸ Kautz (2002). A number of urban housing markets have experienced tremendous growth over the last five years, which has allowed some municipalities to enforce mandatory inclusionary zoning ordinances without offering economic incentives.

Density Bonuses

Density bonuses allow property owners to construct more residential units on a given parcel of land than would otherwise be allowed by a jurisdiction's zoning ordinance. A density bonus is valuable because it reduces a developer's per unit land cost for both affordable and market rate housing. The reduction in land cost allows the developer to maintain a competitive rate of return if the savings are sufficient to offset any financial burden created by including affordable housing in the project.¹⁹ Inclusionary zoning ordinances often allow real estate developers to increase the number of units included in a project by 25% or more in exchange for satisfying the affordable housing requirement.²⁰

- Advantages

Density bonuses are one of the most common economic incentives included in inclusionary zoning ordinances. The public sector benefits from the approach because direct costs are minimal and administrative costs are low. Density bonuses may also serve to moderate market rate housing prices by increasing supply, while still encouraging residential development patterns that preserve green space and reduce the per unit cost of providing public infrastructure.

- Disadvantages

Density bonuses are reliant on strong market demand because they are only valuable to the private sector when additional housing units can be sold or leased at a favorable price. A density bonus may fail to encourage affordable housing development if consumers interested in market rate housing are unwilling to purchase or rent in projects with a high concentration of low or moderate income families. Density bonuses may also be ineffective in markets where consumers have a strong preference for low-density housing. Affluent consumers in weak markets can avoid renting or buying in projects with characteristics they find undesirable because there is a greater stock of vacant housing available to choose from.

¹⁹ Smith (2002). Market rate units effectively subsidize affordable units in a strong housing market, which explains why mandatory inclusionary zoning ordinances do not always have to provide incentives.

²⁰ Fischer and Patton (2001) identify several cities with density bonuses ranging from 16%-25%.

Density bonuses also have the potential to overburden existing public infrastructure by increasing the number of housing units that must be served.²¹ This may result in a fiscal shortfall if low and moderate income housing fails to generate enough property tax revenue to cover the cost of public services.

Expedited Permit Approval

Some inclusionary zoning ordinances streamline the permitting and regulatory approval process for residential development projects that include a specified number of affordable units. Expedited project review benefits the developer by reducing the soft costs required to complete a project. Allowing a project to move forward more quickly may also limit a developer's exposure to shifts in housing demand, interest rate fluctuations, and changing market conditions that can influence the financial viability of a project. The value of expedited project review can be very high in markets where regulatory approvals take multiple years to obtain.

- Advantages

The administrative cost required to establish an expedited project review program may be somewhat high, but over time, the approach can be a cost effective way to encourage the private sector to include affordable housing in market rate projects. Decreasing the time required to construct both market rate and affordable housing can also relieve artificial pressure placed on housing prices in jurisdictions where a cumbersome regulatory approval process is in place.

- Disadvantages

Expedited project review offers a smaller economic benefit to the private sector in markets where regulatory approvals can be obtained relatively quickly. Risk mitigation may also be of limited value in rapidly growing markets where housing demand is anticipated to remain strong. It may be necessary to combine a streamlined permitting process with other economic incentives to provide a financial benefit large enough to offset the cost of including affordable units in a market rate development project.

²¹ Burchell and Galley (2000).

Fee waivers

Fee waivers offer residential developers a direct benefit by reducing the cost required to obtain regulatory approvals. They are sometimes an important component of inclusionary zoning programs in California and other states where local governments rely heavily on impact fees and other forms of development exactions to pay for the construction of public infrastructure. Eliminating such fees can reduce the soft costs required to construct a single-family home by more than \$40,000 in the most heavily regulated markets.²²

- Advantages

Segments of the residential real estate industry have expressed strong opposition to impact fees and other types of development exactions for many years.²³ Voluntary programs that provide an opportunity to avoid these fees may gain political support from these interest groups. Impact fees can also impose a regressive form of taxation on low and moderate income households by raising the overall cost of housing in a community, which can potentially be tempered by an inclusionary zoning program with fee waivers.

- Disadvantages

Exempting affordable housing projects from impact fee requirements reduces the amount of funding available for the provision of public services needed to support new development. This may create fear that higher ad valorem property tax rates will be necessary to address the fiscal shortfall. The threat of higher local taxes may create political opposition to inclusionary zoning programs. On the other end of the spectrum, jurisdictions that assess only minimal permitting and development fees may have little to offer the development community in exchange for constructing affordable housing.

²² Been (2005). Municipal governments in California and Florida assess some of the highest impact fees in the United States.

²³ The National Association of Realtors and the National Association of Home Builders have both ardently opposed impact fees and other types of development exactions for many years.

Alternative Design Standards

Alternative design standards are another incentive offered by inclusionary zoning ordinances. This approach allows developers to limit front and side yard setbacks, reduce parking ratios, or construct affordable units that are smaller than the market rate units included in a project.

- Advantages

One of the primary benefits offered by inclusionary zoning is its ability to harness market forces to encourage the development of high quality housing that is accessible to low and moderate income families. Private sector real estate developers have an economic incentive to construct attractive and functional housing because the project must attract market rate buyers or renters in order to be financially viable. The profit motive, rather than strict government regulation, prevents the development of substandard affordable housing even when design standards are relaxed.

- Disadvantages

Market competition is beneficial in some instances, but it can also be problematic for inclusionary zoning programs. Real estate developers that include low and moderate income housing in a project may be required to provide more amenities at a lower price in order to effectively compete with market rate projects if consumers have a negative opinion of affordable housing.²⁴ This may prevent developers from taking advantage of relaxed design standards even though they are available.

Cash Subsidies

Cash subsidies offer the most direct means of compensating the private sector for constructing affordable housing. They are, however, offered less frequently by inclusionary zoning ordinances than density bonuses, expedited project review, fee waivers or alternative design standards.

²⁴ Schwartz and Tajbakhsh (1997) note that little research has been done to examine the competitiveness of mixed-income housing projects and their ability to retain tenants and maintain rent levels/occupancy in different economic environments.

Real estate developers arguably prefer cash subsidies over other types of economic incentives because the value is quantifiable and can easily be incorporated into a project's pro forma.

- Advantages

From an economic perspective, cash subsidies are the most efficient mechanisms to encourage the real estate industry to participate in various types of affordable housing programs. Administrative costs are low and the magnitude of the subsidy can be compared directly to any additional costs created by the inclusionary zoning ordinance.

- Disadvantages

The popularity of inclusionary zoning is driven in part by its ability to stimulate the development of affordable housing at a relatively low cost to the public sector, while shifting a portion of the financial burden to the private sector. Cash subsidies do not provide this benefit. This explains why alternative economic incentives are much more common. Cash subsidies may also generate political opposition in jurisdictions where voters believe public subsidies for social programs are already excessively high or when subsidies are perceived as a form of "corporate welfare."

Property Tax Abatements

Property tax abatements offer another strong economic incentive to encourage the development of affordable housing. The tax savings accrue to the owner of a housing project over several years and can significantly reduce a property's operating costs. Like cash subsidies, the private sector easily quantifies and calculates the value of property tax abatements.

- Advantages

Local governments may prefer property tax abatements to direct cash subsidies when financial resources are scarce. Spread over multiple years, economic incentives do not require a municipality to identify a source of revenue to fund an inclusionary zoning program.

The second of these advantages may be critical in jurisdictions where there is little public support for housing revenue bonds.

- Disadvantages

Tax abatements suffer from many of the same disadvantages as development fee waivers. Limiting the amount of tax revenue available to a local government may impinge upon its ability to provide public services. A higher ad valorem property tax rate or development fees may be required to maintain service levels for the rest of the community. Additionally, tax abatements are only useful to encourage the construction of affordable rental housing and do not stimulate the construction of affordable owner-occupied units because the tax benefits cannot be realized for multiple years by the developer.

Maintaining Affordability

After providing economic incentives to encourage real estate developers to include affordable units in market rate housing projects, successful inclusionary zoning programs put restrictions in place to ensure units remain affordable over time.²⁵ Frequently recorded against rental properties, deed restrictions achieve this objective. A deed restriction requires the property owner to maintain a specified number of affordable units each year and lease them only to tenants that satisfy the inclusionary zoning ordinance's income requirements. Inclusionary zoning ordinances enacted in several large cities in recent years have imposed deed restrictions lasting 15 to 55 years, while other municipalities have opted for indefinite affordability periods.²⁶

Inclusionary zoning ordinances also use deed restrictions to maintain the affordability of owner-occupied housing. A deed restriction may allow the buyer of an affordable unit to resell the property only to a party that meets the ordinance's income requirements for a specified number of years. The capital gain realized by the original owner may be limited to the amount necessary

²⁵ Padilla (2005) provides a thorough overview of all of the methods discussed in this analysis to maintain housing affordability over time.

²⁶ Brunswick (2004). Denver, Sacramento and San Diego imposed affordability periods of 15, 30 and 55 years, respectively. Boston, MA opted for the "maximum [affordability period] allowable by law". Harmon (2004) states that over a quarter of the jurisdictions with inclusionary zoning ordinances in California impose indefinite affordability periods.

to cover inflation, real estate brokerage fees and other closing costs. Rolling-resale provisions can also be included in deed restrictions to reset the number of years a property must be held by a low or moderate income owner each time it is sold.

Deed restrictions can potentially restrict household mobility by limiting the number of parties eligible to purchase a property in the event the original buyer needs to sell. Some inclusionary zoning ordinances attempt to address this undesirable result by including an equity recapture provision in the deed restriction or by recording a wrap-around second mortgage against the property.²⁷ Both approaches allow an affordable unit to be sold at the prevailing market rate to any buyer, but require a portion of the capital gain realized from the sale to be contributed to the local housing trust fund or to a non-profit organization providing affordable housing. An inclusionary zoning ordinance may alternatively provide a governmental agency or a non-profit agency with the first right of refusal to purchase the property at a favorable price in the event it is put on the market.²⁸

Some jurisdictions have implemented a hybrid approach that prevents affordable units from being sold for a profit for only a short period of time. After the time period elapses, any profits generated from the sale of the property are split between the homeowner and a non-profit entity. For example, Montgomery County Maryland prohibits the sale of an affordable unit for a profit for 15 years.²⁹ Profits are split equally between the homeowner and the county's housing trust fund in the event an affordable unit is sold after the 15 year affordability period expires. A homeowner can retain all of the profits from the sale of an affordable unit after 50 years. The hybrid approach preserves housing affordability over time, while still allowing low and moderate income families to build some wealth as their home appreciates.

Exemptions and In-Lieu Dedications

The characteristics discussed thus far do not vary greatly among the three types of inclusionary zoning. However, there are two unique features included in mandatory and conditional inclusionary zoning ordinances that should be noted. It is not uncommon for mandatory and

²⁷ Padilla (2005).

²⁸ Padilla (2005).

²⁹ Brown (2001).

conditional zoning programs to exempt certain types of residential development. Set-aside requirements are often enforced only when a development exceeds a certain number of housing units.³⁰ Establishing a minimum size requirement may reduce administrative costs and may avoid placing a significant financial burden on small developments.³¹ An inclusionary zoning ordinance may also exempt redevelopment projects or condominium conversions to promote infill development and adaptive reuse.

Another type of exemption included in some mandatory and conditional inclusionary zoning ordinances allows real estate developers to avoid constructing low or moderate income housing by paying fees, dedicating land, or by constructing affordable units at an alternative location.³² In-lieu fees are sometimes allowed when the affordability requirement imposes an undue financial hardship on the developer or in situations where the size of the project makes it impossible to enforce the set-aside requirement.³³ Land dedications may be allowed in markets where developable sites are scarce or a greater number of affordable units can be provided at an alternative location.

In-lieu fees and land dedications are controversial for several reasons.³⁴ First, these provisions may require the private sector to pay less than the full cost of developing equivalent housing units elsewhere. Second, inclusionary zoning ordinances rarely have mechanisms in place to ensure that fees or land dedications are converted into affordable housing units. Third, in-lieu dedications remove the private sector's incentive to construct affordable housing in a cost effective manner and incorporate it into market rate development projects that often provide economically disadvantaged families with access to better schools and employment

³⁰ Brown (2001). Some inclusionary zoning ordinances exempt all projects with less than fifty units, while others ordinances apply to properties as small as a duplex.

³¹ Smith (2002).

³² Padilla (1995). High homeowners associate fees and condominium dues are potentially appropriate reasons to exempt a project in some jurisdictions.

³³ For example, it would be impossible to impose a 15% set-aside requirement on a development project including 5 units, because less than one affordable unit would be required. In lieu fees are beneficial in these situations. Smith (2002) also notes that set-aside requirements can impose a significant administrative burden on small projects.

³⁴ Stockman (1992).

opportunities.³⁵ It may be more advantageous for local governments to require developers to construct mixed-income housing for these reasons.

An offsite development provision does not relieve the private sector of its obligation to construct affordable housing. However, it does increase a developer's flexibility by allowing affordable units to be constructed at an alternative location rather than being included in a project with market rate housing. Critics of this approach argue that it undermines the importance including affordable housing in market rate residential development projects throughout a community.³⁶ Municipalities evaluating this type of provision must balance the importance of mixed-income development against the absolute need for affordable housing units.

Key Findings

Local governments do not simply put inclusionary zoning ordinances in place to remove regulatory barriers preventing the production of affordable housing. They are enacted to encourage the private sector to engage in mixed-income residential development through a unique combination of legal requirements and economic incentives. The following section examines how the severity of these requirements and the magnitude of the incentives impact the effectiveness of an inclusionary zoning ordinance in different economic environments.

III. THE ECONOMIC INCIDENCE OF INCLUSIONARY ZONING

An inclusionary zoning ordinance's ability to stimulate the production of affordable housing is influenced by the magnitude of the financial burden it imposes on the private sector, a municipal government's ability to offset any such financial burden, and the strength of the local housing market. These factors are analyzed individually, and in relation to each other, to predict the effects of an inclusionary zoning ordinance. The potential impact on the profitability of residential

³⁵ Such mechanisms can entail significant administrative costs to guarantee compliance, particularly in the case of in-lieu fees for units to be constructed elsewhere within the jurisdiction.

³⁶ Stockman (1992).

development is discussed first, before examining the role of economic incentives and the importance of housing market characteristics.

The Impact of Inclusionary Zoning on Profitability

Inclusionary zoning ordinances can directly and indirectly affect the profitability of residential development projects. Set-aside requirements and income targets directly affect profitability by limiting the amount of revenue a property can generate.³⁷ As would be expected, ordinances that impose high set-aside requirements and target very low income residents have the greatest financial impact. Inclusionary zoning ordinances can also indirectly affect profitability if there is a negative stigma associated with affordable housing in the market. In these situations, mixed-income projects may generate lower rental rates / sale prices or experience higher vacancy than properties that do not cater to low and moderate income households.³⁸ Real estate developers interested in operating in markets with inclusionary zoning ordinances must consider these factors and determine if a competitive rate of return can be obtained in light of the existing regulatory constraints and economic incentives.

The Role of Economic Incentives

Advocates of inclusionary zoning maintain that this type of land use regulation does not impose a financial burden on the private sector because any direct or indirect effects on a property's cash flow are offset by economic incentives provided by the public sector.³⁹ Some scholars even suggest that density bonuses and other economic incentives included in inclusionary zoning ordinances are so generous that they make mixed-income housing the most profitable option available to real estate developers.⁴⁰ While this may be true in some instances, existing economic literature questions whether local governments fully compensate the private sector for the cost and risk involved in mixed-income housing development. It is a difficult question to answer because the private sector may continue to build in markets where economic incentives are insufficient to offset the cost of developing affordable housing as long as the financial burden can be passed on to other market participants. Therefore, the number of affordable housing

³⁷ Talberth (2005).

³⁸ Schwartz and Tajbakhsh (1997) and Smith (2002).

units produced after the enactment of an inclusionary zoning ordinance may be more indicative of a strong housing market rather than the existence of appropriate economic incentives.

Real estate developers in a competitive market will voluntarily participate in inclusionary zoning programs if doing so allows them to maximize profits. However, many scholars acknowledge that mandatory inclusionary zoning ordinances are more effective than voluntary ones.⁴¹ The fact that the private sector must be compelled to develop mixed-income housing provides some evidence that these projects are less profitable than other alternatives despite the availability of economic incentives.⁴²

It is possible that imperfect market information, rather than a lack of profitability, limits participation in voluntary inclusionary zoning programs.⁴³ Real estate developers may lack the expertise required to complete successful mixed-income housing projects or fear doing so will negatively effect their reputation among more affluent home buyers. The argument is somewhat unconvincing, however, in light of the level of sophistication present in the real estate industry and the amount of literature available on inclusionary zoning.

The economic incidence of an inclusionary zoning ordinance that does impose a financial burden on the private sector is determined by the characteristics of the local housing market. Real estate developers in a competitive market will maintain their required rate of return by charging more for market rate housing or by reducing the amount they are willing to pay for developable land. Developers will leave the market in search of more favorable regulatory environments if the financial burden of an inclusionary zoning ordinance cannot be passed forward or backward in this manner.⁴⁴

³⁹ Tetrault (2000) and Talberth (2005).

⁴⁰ Dietderich (1996). Any economic benefit of a mandatory inclusionary zoning ordinance, over and above the cost of constructing affordable housing, should accrue to landowners rather than real estate developers in a competitive market.

⁴¹ Harmon (2004).

⁴² AIER (2003). Critics of inclusionary zoning argue that it is similar to a price control, decreasing development activity and putting upward pressure on market rate housing prices.

⁴³ Dietderich (1996).

⁴⁴ An influential paper written by Ellickson (1981) outlines the excise tax view of inclusionary zoning.

Strength of the Local Housing Market

Demand elasticity in the local housing market dictates how any financial burden created by an inclusionary zoning ordinance is split between undeveloped landowners and market rate home buyers. Market rate home buyers may bear a significant portion of the financial burden in strong markets where demand is relatively insensitive to price changes. Real estate developers maintain a competitive rate of return in this type of economic environment by increasing the price of market rate housing to offset some or all of the cost of including affordable units in a project.⁴⁵ Alternatively, real estate developers maintain a competitive rate of return by reducing the amount they are willing to pay for undeveloped land in weaker markets where housing demand is sensitive to price changes.

Critics of mandatory inclusionary zoning programs claim that municipalities intentionally use this type of land use regulation to shift a portion of the cost of providing affordable housing to private sector landowners and homebuyers. It is unclear whether or not this is the case, but there are several reasons why local governments may take such an approach. Limited financial resources often prevent local governments from satisfying all of their affordable housing needs through more traditional programs. Inclusionary zoning offers a subtle way to raise additional revenue for the construction of low and moderate income housing, which may face less political opposition than housing revenue bonds or other dedicated funding sources. Additionally, the real estate industry may not oppose the adoption of an inclusionary zoning ordinance in strong markets where additional costs can be passed forward to homebuyers.⁴⁶

Political support for an inclusionary zoning ordinance may erode, however, when a housing market softens. Residential developers that already own building sites cannot pass regulatory costs backwards to undeveloped landowners. Weak housing demand also prevents the costs from being passed forward to market rate homebuyers in the form of higher prices. The private sector is therefore likely to demand greater financial incentives to offset the cost of constructing affordable units.⁴⁷ Inclusionary zoning is less attractive to local governments in this type of economic environment because large public subsidies may be necessary.

⁴⁵ Smith (2002) describes the effect as "cross-subsidization" between low and high income units.

⁴⁶ Calavita et al. (1997) discuss the political implications of inclusionary zoning ordinances.

⁴⁷ Calavita et al. (1997).

Predicting the Effectiveness of an Inclusionary Zoning Ordinance

The analysis presented thus far demonstrates that an inclusionary zoning ordinance can have characteristics of both a public subsidy and an excise tax. Therefore, the ability of this type of land use regulation to stimulate the production of affordable housing can be predicted by analyzing the interrelationship between the strength of the local housing market and the economic incentives offered by the public sector. The relationship is briefly summarized in Table 2 and described in greater detail below.

Table 2. Predicting the Effectiveness of an Inclusionary Zoning Ordinance		
	<i>Generous Economic Incentives</i>	<i>Few Economic Incentives</i>
<i>Strong Market</i>	-Very Effective -Minimal Impact on Market Rate Housing Prices	-Moderately Effective -Significant Impact on Market Rate Housing Prices
<i>Weak Market</i>	-Moderately Effective -Minimal Impact on Market Rate Housing Prices	-Ineffective -Minimal Impact on Market Rate Housing Prices

Strong Markets/Generous Incentives

Mandatory and conditional inclusionary zoning ordinances produce the greatest number of affordable units in strong housing markets, where municipalities offer generous economic incentives. Real estate developers have an incentive to produce mixed-income housing in this type of environment because density bonuses and other public subsidies are sufficient to offset a large portion of the financial burden imposed by the ordinance. Additional costs required to construct affordable units, over and above the amount of the economic incentives, can be passed forward to market rate homebuyers.

The success of mandatory inclusionary zoning ordinances in California over the past two decades illustrates the effectiveness of this type of affordable housing program when market demand is strong and generous economic incentives are available. Inclusionary zoning has encouraged the

production of over 34,000 housing units accessible to low and moderate income families.⁴⁸ The results are arguably attributable to a historically robust housing market and the availability of various types of incentives.

Strong Markets/Few Incentives

A mandatory or conditional inclusionary zoning ordinance enacted in a strong market may encourage the development of affordable housing even in the absence of economic incentives. Developers maintain a competitive rate of return by passing the cost of the affordable units forward to market rate homebuyers. The ordinance operates as an excise tax in this scenario.

Two large cities in California took this approach after adopting inclusionary zoning ordinances in the early 1990s.⁴⁹ Local officials in San Diego chose not to offer economic incentives as part of their inclusionary zoning program because an economic analysis conducted for the housing commission indicated that additional costs imposed on real estate developers could be passed forward to market rate homebuyers. San Francisco also limited economic incentives to building permit and environmental review fee refunds for affordable units included in mixed-income projects. Despite these limitations, several hundred affordable housing units have been constructed.

Weak Markets/Generous Incentives

Inclusionary zoning is less effective in weak housing markets because the cost of producing affordable units cannot be easily shifted to the private sector.⁵⁰ Real estate developers must reduce land bids or request greater economic incentives from the public sector in order to maintain a competitive rate of return. An inclusionary zoning ordinance may still encourage the production of mixed-income housing, but generous economic incentives may be necessary to prevent developers from exiting the market.

⁴⁸ Calavita et al. (2004).

⁴⁹ Brunwick (2004).

⁵⁰ Burchell and Galley (2000).

Local governments in both California and New Jersey were forced to recognize the need for economic incentives in weak housing markets during the mid 1980s and early 1990s when recessions created political opposition to inclusionary zoning ordinances.⁵¹ Municipalities previously unwilling to offset the private sector's cost of constructing affordable housing were forced to do so in order to appease development interests.

Weak Markets/Few Incentives

An inclusionary zoning ordinance has the lowest probability of success in a weak housing market where the local government offers few economic incentives. The cost of producing affordable units cannot be passed forward to market rate homebuyers in this environment and the full financial burden of producing affordable units falls on real estate developers, unless it can be shifted to landowners. Developers will exit the market in response to the financial burden.

Existing research provides some evidence that municipalities with inclusionary zoning ordinances in place respond to economic downturns by increasing the incentives available to residential developers.⁵² However, a more proactive approach could help stabilize the production of affordable housing. Policymakers may find it advantageous to offer economic incentives that are both valuable to the private sector and acceptable to the public sector in a variety of economic environments.

Key Findings

The structure of the ordinance and the strength of the local housing market influence the effectiveness of inclusionary zoning. It is therefore difficult to make general statements about the merits of this type of affordable housing program that are appropriate for all markets and all types of economic environments. However, the potential success of an inclusionary zoning ordinance can be evaluated within the confines of an individual housing market at a given point in time.

⁵¹ Calavita et al. 1997.

⁵² Calavita et al. (1997) and Calavita et al. (2004).

IV. CONCLUSIONS

Inclusionary zoning potentially offer an innovative way to increase the supply of low and moderate income housing by requiring real estate developers to include affordable units in market rate residential development projects. The approach not only encourages the production of affordable housing, but also ensures it is geographically disbursed throughout a community in order to provide working families with better access to employment and educational opportunities. A number of local governments throughout the United States have implemented inclusionary zoning programs over the last twenty years and many have increased the housing options available to economically disadvantaged residents.

There is, however, some evidence that inclusionary zoning can discourage residential development, put upward pressure on market rate housing prices, and decrease undeveloped land values in certain types of economic environments. Local governments considering inclusionary zoning programs must therefore offer appropriate economic incentives to offset the private sector's cost of developing affordable housing in order to avoid these externalities. A number of other best practices can also be drawn from the experience of urban areas throughout the United States that have adopted inclusionary zoning programs:

Define the Objectives

Successful inclusionary zoning programs clearly articulate a community's affordable housing needs and outline a process to deliver a finite number of affordable units.⁵³ Set-aside requirements and income targets are designed to reflect housing needs in all areas of the city and across the income distribution.⁵⁴

⁵³ Pindell (2007).

⁵⁴ Harmon (2004).

Multiple Approaches

Inclusionary zoning rarely addresses all of a community's affordable housing needs. It must operate as a single component of a comprehensive affordable housing program.⁵⁵ In the current economic environment, policymakers must focus on both the production of affordable housing and efforts to keep low and moderate income families in homes they already own.

Understand the Nature of the Affordable Housing Problem

A shortage of affordable housing can be caused by government regulations limiting housing supply or by strong market demand.⁵⁶ Municipalities must understand the factors limiting the availability of workforce housing in their jurisdiction in order to structure an effective inclusionary zoning program. Steps must also be taken to identify the segments of the community most in need of affordable housing and to determine whether rental or owner-occupied housing is most appropriate.

Consider Excise Tax Effects

An inclusionary zoning program designed to increase the availability of low and moderate income housing can potentially create an affordability problem that does not already exist if it puts upward pressure on market rate housing prices.⁵⁷ Working families ineligible for housing assistance may be forced out of the market as prices escalate. Public officials must mitigate potential excise tax effects by ensuring appropriate and diverse economic incentives are in place to defray the private sector's cost of providing affordable units.⁵⁸

⁵⁵ Calavita et al. (1997).

⁵⁶ Padilla (1995).

⁵⁷ Conine (2000) notes that inclusionary zoning is problematic because it can put upward pressure on market rate housing prices in areas already experiencing affordability issues.

⁵⁸ Rose et al. (2004) and Calavita et al. (1997).

Carefully Evaluate Conditional Inclusionary Zoning

Conditional inclusionary zoning is potentially beneficial because it provides a municipality with greater flexibility to negotiate set-aside requirements and income targets on a case-by-case basis. However, it can also create political controversy if it encourages negotiations between real estate developers and local officials outside of the public view.⁵⁹ Local governments must balance the advantages of conditional inclusionary zoning against political opposition that may arise from its use.

Regional Implementation

Inclusionary zoning programs that impose an economic burden on the private sector may encourage real estate developers to relocate to other parts of the region. This can perpetuate urban sprawl and concentrate affordable housing in remote areas that do not provide working families with access to employment centers. Implementation of a regional inclusionary zoning program may address the problem.⁶⁰

Emphasize Workforce Housing

Unless a housing market is extremely competitive, it may be difficult to encourage market rate renters and home buyers to reside in development projects with high concentrations of very low-income residents.⁶¹ It may be advantageous to initially adopt broad set-aside requirements and income targets to ensure market rate consumers can be attracted to mixed-income projects. The economic incentives required to encourage the development of moderately priced housing units may also be smaller because this type of development imposes a less severe financial burden on the private sector.⁶² Irrespective of the income targets chosen, steps should be taken to ensure affordable units are functionally equivalent to market rate housing and dispersed throughout a project.

⁵⁹ Pindell (2007).

⁶⁰ Morgan (1995).

⁶¹ Smith (2002).

⁶² Calavita et al. (1997) and Burchell and Galley (2002).

Compatibility between Planning Objectives

Inclusionary zoning programs should be designed to compliment other policy objectives local governments seek to advance. It may be advantageous to structure programs in a manner that encourages urban infill, transit oriented development, and other desired land use patterns.

Convert Development Fees into Affordable Units

Inclusionary zoning programs that allow real estate developers to contribute fees in-lieu of constructing affordable units are criticized because they do not encourage the private sector to integrate affordable housing into market rate development projects.⁶³ Local governments should carefully weigh the advantages and disadvantages of in-lieu fees before including them in an inclusionary zoning program. If they are allowed, provisions should be put in place to ensure the fees are sufficient to cover the cost of constructing affordable units elsewhere. Effort should also be made to ensure fees are converted into affordable units within a reasonable period of time.

Mechanisms to Maintain Affordability

Effective inclusionary zoning programs include various types of provisions to ensure affordable units remain accessible to low and moderate income families over time. A number of programs enacted by large cities throughout the United States impose deed restrictions that require units to remain affordable for fifty years or more. Over time, enforcement of these provisions will depend on title companies, attorneys, realtors, and loan officers who are involved in future sales of affected properties. Thus, it may be advantageous to explore deed restrictions and wrap-around mortgage options that allow the local housing trust funds to capture capital gains generated by the sale of owner-occupied affordable housing units.

⁶³ Padilla (1995).

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