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Missed Opportunities: Assessing and Leveraging Requirements, Incentives & Tradeoffs in Affordable Housing Development

Insights from Portland, Oregon's Mandatory Inclusionary Housing Policy

By Mike Kingsella

The United States is experiencing a housing crisis driven by a shortage of millions of homes. This housing underproduction disproportionally burdens renters and low-income households (Up for Growth®, 2018). Artificial barriers, exclusionary zoning, and opposition from residents combine not only to limit access to housing that is affordable (U.S. Department of Housing and Urban Development, 2005), but to compound inequality (Rouse, Bernstein, Knudsen, and Zhang, 2021) and exclude families and individuals from high-opportunity neighborhoods (Chetty, Hendren, Katz, 2015).

In response to housing crises across the nation, some jurisdictions have enacted policies to create more affordable housing in mixed-income buildings by requiring or incentivizing developers to set aside a share of newly constructed units at below-market rates. These policies range in type and specification across the country, but generally offset some of the development income lost on below-market rent through incentives. The types of incentives vary, with some jurisdictions offering physical development bonuses, while others exempt property taxes for a period of time (Urban Land Institute, 2016). The most utilized approach is enacting inclusionary housing (IH) policies, either mandatory or voluntary. IH policies typically offer a range of development and funding options that target higher affordability levels with a larger share of units, or deeper affordability with fewer units set aside. In some instances, a fee-in-lieu option is offered as an alternative.

A review of IH policies around the country finds that several conventions or standard policy approaches have emerged. These common practices have varied impacts in different market contexts and often do not incorporate thorough analysis grounded in real estate development feasibility. This policy brief examines how establishing set-aside and affordability pairings without careful calibration rooted in current housing market economics can create missed opportunities to both maximize the number of affordable units produced and ensure lasting affordability by adjusting offsets.

> Policies encouraging affordable units in market-rate developments must be carefully calibrated to ensure the program itself does not become an artificial barrier to housing.

A majority of Up for Growth members, including developers, practitioners, and advocates, agree that the focus of IH policies should be on maximizing the number of affordable units created. Incentive programs must work with the market. They must be carefully calibrated and adjusted to the conditions present in each market and be regularly updated to reflect changing market conditions. Poorly calibrated policies can have unintended impacts that reduce the overall supply of units produced, resulting in lower affordability across a market and fewer below-market-rate units.

This policy brief uses the City of Portland's mandatory Inclusionary Housing policy (City of Portland Inclusionary Housing. § 30.01.120. 2019) to evaluate the tradeoffs between the achievable set-asides and tax exemption offsets. Development proformas and current market data provide a robust, economically grounded analysis to understand if there are leverage points in the affordability and exemption periods that better align the incentive to generate public benefit. While IH policies are a common tool, the findings apply to numerous voluntary and mandatory incentive programs, including density bonus programs and tax-exempt multifamily housing private activity bonds.

Key Findings

- Nearly 60% of Up for Growth members, including policy, practitioner, and advocacy organizations, prioritize maximizing the number of affordable units created over creating deeper affordability.
- There are opportunities to increase the number of affordable- and market-rate units by expanding the choice set of incentive options, which are often limited only to the affordable units or capped at a limited number of years in duration.
- As many American communities struggle with persistent housing unaffordability, policymakers have the opportunity to maximize the number of affordable units produced and to ensure lasting affordability. To accomplish these twin objectives, policymakers must carefully calibrate tradeoffs between short-term forgone property tax revenue and long-term public benefit.
- Local jurisdictions can prioritize targeted outcomes around the depth of affordability and the percentage of units set aside in mixed-income developments by leveraging longer tax exemption periods.

How Affordable Housing Incentives Work

Market rate multifamily housing development operates in a highly competitive marketplace where capital seeks desired rates of return and is flexible in selecting locations around the country based on needed market conditions. Policies that require mixed-income development with a certain number of units set aside with below-market rents adversely impact development feasibility unless there are mechanisms to offset that impact. This also holds true for voluntary policies that are implemented to incentivize more affordable unit production.

To overcome this obstacle, IH policies and other incentive programs offer benefits that offset the reduction in rental revenues, decreasing the adverse impact on development feasibility. These incentives can be physical, like increasing height limits or allowing more density, or financial, such as exempting the building from property taxes for a period of time or reducing or waiving impact fees. A crucial distinction in this context is that foregone revenue (for example, a tax abatement) is different than devoting resources to building affordable housing. Building and operating affordable housing is an expensive undertaking for local jurisdictions. A benefit of these policies to governments is that they can leverage market-rate development to produce affordable housing units without having to devote resources to fully fund the expenditure in advance, and they can use forgone future revenue over several years to maximize the public benefit.

About Up for Growth

Up for Growth® is a national 501(c)(3) cross-sector member network committed to solving the housing shortage and affordability crisis through data-driven research and evidence-based policy.

Our mission is to forge policies and partnerships to achieve housing equity, eliminate systemic barriers, and create more homes.

Launching Policy Briefs

Up for Growth is excited to launch its series of policy briefs where we offer evidence-based and data-driven analysis of a variety of pro-housing policies. Each brief will focus on a specific local, regional, state, or federal policy and will inform policymakers, advocates, and practitioners as they advance meaningful solutions to housing underproduction. Up for Growth's member network will be surveyed to obtain critical insights and considerations to inform policies that further our organization's mission.

Members can email policy@upforgrowth.org to submit their ideas for policies to be evaluated in future briefs.

An Overview of Policy Levers and Tradeoffs

Across the U.S., 531 jurisdictions in 34 states have enacted IH policies, as shown in the map below. These programs vary across six typical policy parameters:

Set-aside requirement. Defines how many units (as a share of the total) must be rented at affordable, below-market prices.

Depth of affordability. Defines the affordability level based on household income thresholds, typically 60% or 80% of the area's Median Family Income (MFI).

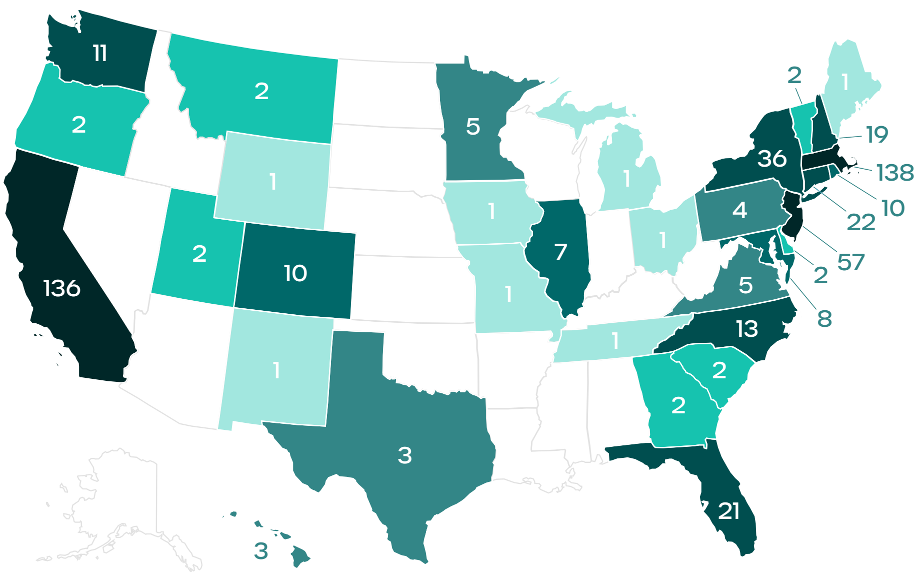
Length of affordability. Defines the duration of affordability for the units with below-market rents.

Voluntary versus mandatory. Voluntary policies rely on offsets to incentivize program participation. While mandatory policies are required, they still need to ensure offsets are financially feasible. The impacts of both policies vary by market conditions.

Application of policy. Policies can require a minimum number of units, may use specific policy geographies, or may be differently applied to rental and ownership products. Others are more broadly applied.

On-site delivery or fee-in-lieu. Some policies require the delivery of units on-site in mixed-income developments. In contrast, others allow for off-site development or the payment of a fee-in-lieu, typically used to fund public investment in affordable housing.

These policies typically offer several options, blending the depth of affordability with the set-aside or offering additional incentives for greater depth of affordability. This allows the developer to test different scenarios in their proforma model and evaluate the feasibility impacts of these policy options.



Map Source: Grounded Solutions Network, Inclusionary Housing Map & Program Database. Data are filtered to show the number of cities with "traditional inclusionary housing" policies in each state.

Finding Common Ground on IH Policies

Up for Growth surveyed its member network about the tradeoffs inherent in IH policies. Advocates, developers, and practitioners responded with the following comments on policy design.

More than half of advocates and nearly three-fourths of practitioners favor **maximizing the number of income-restricted units** produced under IH policies, even if that means not every building is mixed-income.

More than half of advocates and nearly two-thirds of developers and practitioners favor **greater unit set-asides** over deeper affordability.

Advocates were split evenly between maximizing units set aside versus optimizing for the duration of affordability, while most developers and practitioners prioritize maximizing units set aside.

Evaluating IH Policy in Portland, OR

To take a deeper look at these affordable housing incentive programs, we evaluate Portland, Oregon's IH policy as a case study to demonstrate the tradeoffs between tax exemption incentive periods, affordable unit set-asides, and depth of affordability. Survey results of Up for Growth members indicated a preference for programs that produce more units (set-aside) or that target a lower depth of affordability, but less interest in reducing the affordability period. We use Portland market data, but our analysis has been modified to represent a broad range of market conditions so that the implications are generalizable.

The City of Portland defined an explicit set of priorities to guide the calibration and implementation of its IH policy. The first was to maximize the length of affordability—effectively permanent at 99 years, the longest of any policy in the country. Second, the city prioritized delivering units on-site rather than maximizing fees in-lieu revenue. Third, the city's policy design reflects a preference for units at 60% of MFI. An option for 80% of MFI is offered due to state statutory requirements, but it is calibrated to be less attractive from a financial feasibility standpoint. As a result, the preferred outcome of the city's policy choices is that 10% of units are set aside.

The incentives vary across the city, with the central city offering a tax abatement on all units in buildings with a floor area ratio (FAR) of 5.0 or higher. The increased abatement is an offset of the increased construction costs associated with high-density (type 1) construction. Less than 10% of projects built in Portland since the implementation of its IH policy have been both located in the central city and had a FAR of greater than 5.0. Therefore, most projects have only received a tax abatement on the affordable units set aside. Since implementing IH in 2017, the policy has not been recalibrated to changing market conditions. This policy analysis explores how expanding the use of property tax abatements could increase unit production, calibrated to market conditions.

Set-Aside and Tax Exemption Period: How many more affordable units could be developed with an expanded tax abatement?

A property tax exemption can be a powerful incentive to offset revenue loss for below-market rents and often helps maximize affordable unit production. While reducing tax revenue for a distinct period, tax exemption offers the advantage of requiring no new spending. However, Portland's current tax exemption program does not offset the revenue loss of providing below-market rents and adversely impacts financial feasibility. The city's policy, a 99-year affordability requirement at 60% of MFI and 10-year tax abatement on 10% of units set aside, impacts cash flow during project development and further complicates project financing and underwriting.

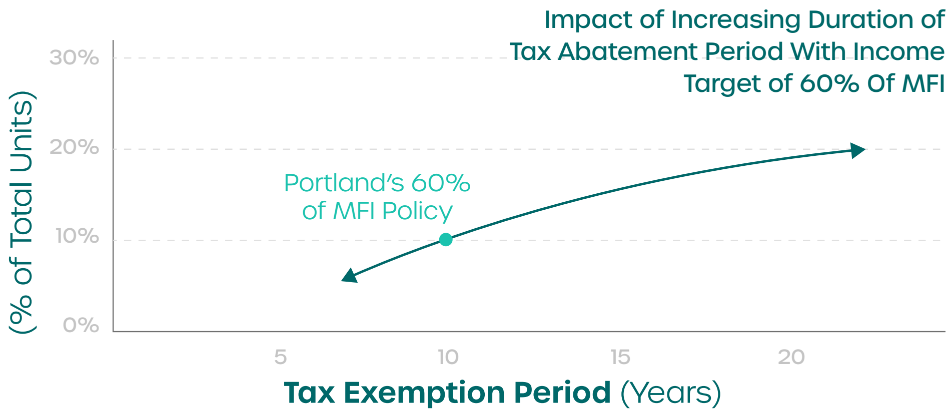
Our analysis explored two possible changes to the city's current IH policy: (1), reducing the affordability period to fewer than 99 years and (2), applying the tax abatement to all units. Both approaches are more effective in aligning incentives to current market conditions and reducing adverse impacts on financial feasibility. Reducing the affordability period is less effective than extending the tax abatement; therefore, the remainder of this analysis explores how the tax abatement can be used to increase unit production.

To model the impact of property tax exemptions on affordable housing production, we held constant the affordability level at 60% of MFI and the financial feasibility of a prototypical building subject to Portland's IH policy (see sidebar). We found that:

- The current IH policy adversely impacts financial feasibility. Increasing the tax exemption to all units for ten years would align the policy with current market conditions (but would not increase the number of units set aside).
- The effectiveness of increasing the duration of tax exemptions – on 10% set-aside units only, per the existing policy – decreases over time.
- Increasing the tax exemption period to 22 years on all units could double the number of income-restricted units set aside in new developments.
- This pattern is consistent under different market-rate rents, affordability levels, and development costs, though the magnitude of the impact can vary.

Portland's Mandatory IH Policy Design

- A requirement for all newly constructed developments with 20+ units
- Can set aside 10% of units at 60% of MFI
- Or can set aside 20% of units at 80% of MFI
- Other options for building off-site, unit mix reconfiguration, and fee-in-lieu (not analyzed in this policy brief)
- Modified requirements outside the central city boundaries (not examined in this brief)
- 99-year affordability requirement
- 10-year property tax exemption on all units in the central city (only on affordable units outside the central city)
- Enacted in 2017
- Portland's 2021 MFI was $96,900



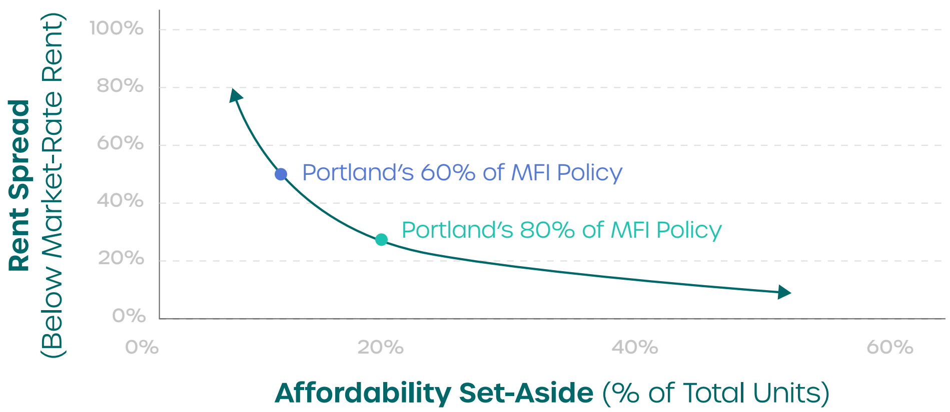
Implications of Different Market Conditions on the Number of Units Set Aside

The tradeoff of set-aside and affordability level is not the same across all cities due to varying market conditions, including the relationship of MFI to market rent, construction costs compared to market rents, and in the context of a tax exemption offset, the rate of taxation. In Portland, rents are highest in the central city and reach approximately 110% of MFI. That means a policy targeting 60% of MFI is about 50% of MFI below-market rents, and a policy targeting 80% of MFI is 30% of MFI below-market rents. An important consideration when designing an IH policy is that market rents vary across a city. There are places in Portland where new construction rents are closer to 90% of MFI, which means the IH policy's impact is lower than in higher rent areas.

The difference between the achievable market rent and the depth of affordability is critical in calibrating the set aside of units. For example, suppose market rent is 80% of MFI and the policy goal targets a depth of affordability of 80% of MFI. In that case, there is little to no impact on project feasibility and incentive offsets would not be required. The chart below evaluates how holding project feasibility constant and offering a 10-year full tax abatement would impact the percentage set-aside of units in different market conditions (within or across other markets).

In general, where market rents differ significantly from the income target, a 10-year tax abatement becomes less effective, decreasing the percentage of units set aside. Conversely, in locations where the spread between market rate and the depth of affordability is small, tax abatements can be an effective tool for achieving set-asides as high as 40% of units.

In the case of Portland, the city's stated preference for 60% of MFI units can be observed when analyzing locations in the city with the highest rents. A 10-year tax abatement would offset 10% of units at 60% of MFI but only 17% of units at 80% of MFI. The difference between the two approaches is significant and would likely push developers toward selecting the 60% MFI option.



Analysis Methods

A proforma model was used to estimate the feasibility impacts of changes to Portland's affordability and tax exemption periods. Our model evaluated potential implications on the feasibility of podium construction, a building type commonly built in Portland's central city.

Proforma analyses are commonly used to evaluate the financial feasibility of new development. They assess the revenues and costs of development, test different design options on a site, and calculate the rate of return measured against market expectations.

Inputs to the analysis include site size and zoning, market rents, construction costs, unit size, unit counts, and parking requirements, among others. Please find more detail on the technical analysis here.

Policy Implications

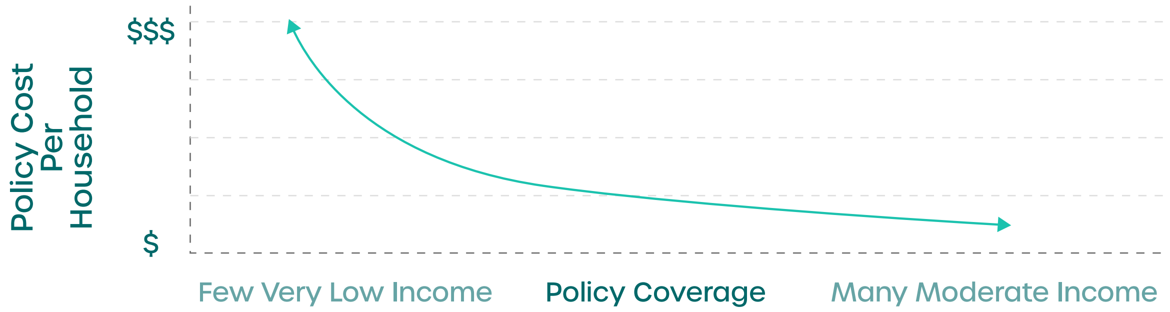
Policymakers have a complicated set of tradeoffs to consider. This policy brief demonstrates the implications of calibrating program parameters in different market conditions. To do this, we focus on quantifying the effectiveness of tax abatements on financial feasibility as a means to produce more affordable units in a variety of market conditions.

Up for Growth's members suggested that there is common ground when weighing the policy tradeoffs inherent in these programs. When presented options, a diverse set of members had a stated preference to maximize the number of affordable units created on-site over other program aspects: deeper affordability, length of affordability, or building units off-site.

Our analysis also concludes that tax exemption is a powerful policy tool that can be used to increase affordable housing production. The chart below is helpful for communities as they evaluate tradeoffs. Depending on market conditions, some policy goals are challenging to achieve given the incentives available to offset reductions in feasibility. Decreasing affordability periods, for example, produces more units today but does so potentially at the expense of additional units 20 to 30 years in the future. On the other hand, tax abatements do not sacrifice future unit affordability. They can be better leveraged to produce a range of policy combinations likely to spur the development of additional affordable units in the short term.

Future research can explore non-economic incentives such as height or density bonuses and parking reductions. Some Up for Growth members expressed a preference for those incentives over tax exemptions to offset the impacts of affordability requirements on development feasibility.

Another lever that would benefit from additional analysis and survey is lasting affordability. Shorter affordability periods can allow larger set-aside requirements or deeper affordability levels. More research is needed to understand what impacts the health of the housing market most: lasting affordability, depth of affordability, or the number of households that can be assisted today (the set aside).



Endnotes

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UP FOR GROWTH®

1627 Eye Street NW
Suite 1130
Washington, DC 20006

202.716.2064
upforgrowth.org
support@upforgrowth.org