NATIONAL MULTIFAMILY HOUSING COUNCIL

Tool: Inclusionary Zoning

THE HOUSING AFFORDABILITY TOOLKIT

Developed in Partnership with
HR&A Advisors

Inclusionary Zoning

Inclusionary zoning policies can increase affordability if they are flexible, properly structured with sufficient incentives, and limited to strong housing markets.

What Is Inclusionary Zoning?

Inclusionary zoning policies require new rental housing developments to include a certain percentage of apartments at below-market rents in order to be approved. In exchange for those affordable units, most policies offer incentives that offset the costs of lower rents.

Common Incentives

- Additional development density
- Reduced parking requirements
- Accelerated approval
- Tax abatements*
- Impact fee waivers
- Design flexibility
- By-right development*
- Public financing

> **“Since 1974, almost 900 local governments have enacted inclusionary zoning policies, either mandatory or voluntary. Voluntary programs allow developers to determine whether market conditions are right for participation."**

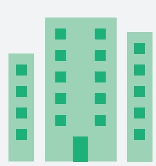
How Inclusionary Zoning Works

The economics of inclusionary zoning policies are often misunderstood. Inclusionary policies are viewed by many local governments as ‘costless’ solutions to their housing affordability challenges. **In reality, inclusionary policies impose significant costs on new rental development by reducing total rents on the property and making it harder for developers to get the financing they need to build.**

A well-designed inclusionary policy adheres to four principles that minimize and offset the costs the policy creates.

The Four Principles of Effective Policies

Provide a sufficient range of incentives to offset reduced rents



Target neighborhoods with strong housing markets

Provide developers with flexible participation options in housing markets

Enable simple administration and developer participation

*Additional information on these incentives is provided in subsequent tools documents.

Provide Sufficient Incentives

Without sufficient incentives, inclusionary zoning can actually reduce housing affordability.

If incentives do not cover the gap between the below-market rents and market-rate rents, owners will either have to raise the rents for the market-rate units or cancel plans to develop the property altogether. Both scenarios undermine affordability.

In markets where there is strong demand, the rents for market-rate units can rise to cover the reduction in rents on inclusionary units, shifting the cost of the reduced rent onto the market-rate units.

In markets where the demand for rental housing is not strong enough to support higher rents, projects on the margin may not be built. The decrease in development restricts supply and increases competition for existing housing, contributing to displacement and higher rents for existing rental housing.

Decreased Development Portland, OR

Since Portland's inclusionary policy took effect in February 2017, multifamily building permit applications have decreased 65%. The drop appears to be at least partially because the policy failed to provide sufficient incentives and created an onerous administrative process.

Source: Portland Housing Bureau

Even modest rent reductions not recovered through incentives significantly reduce the financing a property can secure. A $100 per month rent reduction for a single unit translates into approximately $20,000 less per unit in financing.

IMPACT OF RENT REDUCTION ON FINANCING

-$100 = -$20K

Reduction in Monthly Rent for 1 Unit = Financing Gap

The "cost" of an inclusionary policy to developers depends on how many below-market units are required and the allowable rent levels for those units. This example compares the burden of a policy that requires 15% of the units to be at 80% AMI* to a policy that requires 10% of the units to be at 60% AMI.

	Level of Affordability		# of units		Rent Reduction		Financing Gap
A	-$200 (80% AMI)	X	30	=	-$6K	=	-$1.2M
B	-$400 (60% AMI)	X	20	=	-$8K	=	-$1.6M

$100 reduction in monthly rent supports $20,000 in debt, assuming a 30-year amortizing mortgage with an interest rate of 5%.

AMI (Area Median Income) is a Department of Housing and Urban Development-determined measure of the household income for the middle household in a region.

Inclusionary zoning can also include for-sale homeownership housing. However, this is not addressed within this document.

Establishing Effective Incentives

Stakeholders should take a holistic approach when designing incentives.

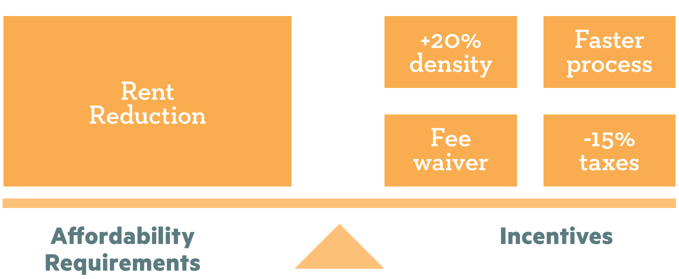
Collaborate with property managers, owners, and developers. Establishing a set of affordability requirements and offsetting incentives tailored to the conditions of a specific housing market is difficult absent input from stakeholders. These private sector partners are likely to have a more in-depth understanding of local market conditions from neighborhood to neighborhood and the complexities of multifamily housing finance than policymakers. Private sector partners substantive involvement in designing the program is necessary for its success. Since housing markets change over time, it may be necessary to engage them even after the policy has been adopted to modify it to adapt to changing market conditions.

Stakeholder Input Nashville, TN

In 2015, Nashville's Metro Planning Department convened stakeholders, including developers and lenders, to provide input on an inclusionary zoning policy through meetings and individual and group interviews. Their participation and input on land costs, development costs, rental rates and incentives helped develop a viable inclusionary policy that was adopted in 2016.

Possible incentives

- Additional development density "bonuses"
- Reduced parking requirements
- Accelerated approval
- Tax abatements
- Impact fee waivers
- Design flexibility
- By-right development
- Public financing



Policymakers need as many incentive options at their disposal as possible to accommodate the diversity of their housing market needs. Rarely will just one incentive program sufficiently offset reduced rent for every type of project and in every neighborhood. In some projects, additional density is more valuable in covering rent gaps than tax abatement. In other neighborhoods, the opposite may be true. Some developments may need to combine incentives to cover rent and financing gaps.

While density bonuses are the most common policy incentive used, they are not a panacea. Density bonuses are not always the most effective for many reasons.

1. They only work in a neighborhood where there is enough demand to absorb the additional units, otherwise there is no economic benefit to the bonus.
2. They only work if the extra density doesn't change the type of construction, such as going from a less expensive mid-rise building to a much more expensive high-rise property. In those cases, the increased construction costs will typically exceed the value of the density bonus.
3. The density bonus must allow for developers to add more market-rate units than the number of below-market rents required. A one-for-one incentive will not offset the reduced rent in an inclusionary unit.

DENSITY BONUS IN PRACTICE

Target Strong Markets

Effective inclusionary policies should target strong housing markets and vary according to market conditions.

> **"Areas not experiencing any or much market-rate development will likely not generate significant results from an IZ policy."**
>
> – Urban Land Institute

Inclusionary policies require strong housing markets to be effective. They depend on market-rate development to produce inclusionary units and demand from middle- and high- income renters to offset the reduced rent for inclusionary units. Neighborhoods with low rates of vacancy, high levels of construction, and steady growth in rent are most conducive to supporting an inclusive policy. Community perception about the strength of a real estate submarket often exceeds the actual strength of the market. A clear, data-driven assessment of the strength of the housing market is imperative for an informed discussion about where an inclusionary policy could be feasible.

Most cities do not have a strong enough housing market to support a citywide mandatory inclusionary policy. Many will have some neighborhoods with lower market rents, higher vacancies or limited development activity where incentives simply can't offset the cost of the below-market-rent inclusionary units.

Citywide inclusionary policies should include different incentives and requirements for different neighborhoods. A downtown housing market where large residential towers are being developed calls for a different policy than a former warehouse district where industrial buildings are being converted to loft apartments. Both might be strong markets, but the appropriate incentives and the number and kind of required below-market units will differ significantly. The inclusionary policy must be targeted accordingly to reflect these differences.

Inclusionary policies should be revaluated periodically. Since effective inclusionary programs require strong housing markets, inclusionary policies should be reviewed on a regular basis to determine if the incentives they offer still cover the rent gap in the current market conditions. Once again, engaging stakeholders, such as developers and property owners, is critical to ensure that the affordability requirements don't exacerbate housing affordability.

Regular Policy Updates Boston, MA

The City of Boston adopted an inclusionary zoning policy in 2000 that required any multifamily developer constructing 10 or more units, receiving funding from the city, developing property owned by the city, or receiving zoning flexibility from the city, to make 10% of the units affordable (or build the required units off site). In 2015, the city changed the on-site affordability requirements after a feasibility study and stakeholder input determined the current requirements were misaligned with market conditions. They began another policy review in March 2018.

Source: City of Boston, Boston Globe

Offer Flexibility

Effective inclusionary policies offer flexibility to developers in how they participate.

Mandatory inclusionary policies can harm affordability. If the policy does not offer sufficient incentives to cover rent gaps, developers will have to raise rents for the market-rate units or cancel plans to build. The opportunity for a mandatory inclusionary policy to harm housing affordability is significant because most are relatively complicated, apply across multiple neighborhoods and building types, and include a range of affordability requirements.

Voluntary policies are less risky for affordability. If the incentives in a voluntary program don't align with market conditions, developers can simply choose not to participate, but they can still build the housing the community needs. Assuming the policy is well-designed and incentives to include below-market-rent units outweigh the costs, developers will be motivated to participate.

Mandatory/Voluntary Mix New York, NY

NYC uses both mandatory and voluntary inclusionary policies in different areas of the city. The mandatory policy is closely linked to areas of the city where rezoning to allow for higher density is planned or has occurred. The voluntary program is used in neighborhoods that cannot support a mandatory policy.

Source: Housing Virginia, Fairfax County, VA

Engaging developers is the best way to ensure the best outcome for stakeholders and policymakers. Attracting sufficient participation can be a challenge with any inclusionary policy. As previously noted, if a mandatory policy doesn't offset the program costs, developers will build elsewhere. If the program is voluntary, they will opt out. Working with developers to design policies is one way to ensure they will be effective.

Voluntary Policy Fairfax County, VA

Fairfax County's Workforce Dwelling Unit (WDU) Program incentivizes development in high-density areas. If developers choose to opt-in to providing affordable workforce units within their high-rise developments, they are granted an up to 20% density bonus. Since these buildings are already employing higher-cost construction, the bonus has real economic value. In addition, the policy targets households at higher incomes, those earning between 60% and 120% of AMI, which reduces the rent gap between the market-rate and workforce units. Twenty-five include units that participate in the WDU program, creating approximately 1,200 units for workforce renters.

Source: Housing Virginia, Fairfax County, VA

Include a payment in-lieu option. Many inclusionary policies allow developers to pay a fee to the jurisdiction in-lieu of including below-market units in their development. These set fees reduce risk to the developer and encourage their participation in the program. Under them, they know they won't face unexpected costs from delays in finding a qualified resident, ongoing monitoring requirements, or other additional requirements.

The developer can weigh the cost of the fee in-lieu against the incentives the policy offers and make a choice about whether and how to participate. If the policy is mandatory, the fee still eliminates the administrative burden and risks of participation. Localities can use these fees to provide grants to nonprofits to build affordable housing where it is needed most and may be more cost effective to produce.

Keep It Simple

Inclusionary policies that are simple to comply with are more effective.

Administratively complex programs harm affordability. They take more time and resources with which to comply, which increases their "costs" to developers and results in higher rents or fewer units being developed if developers opt out.

Keep income documentation and reporting requirements simple. Don't default to burdensome federal requirements. Federally funded affordability programs are overly complex and discourage private sector participation as a result. Many local inclusionary policies default to burdensome federal rules for income documentation and recertification because they think it is easier for their local housing departments to administer. That simplicity comes at a cost to developers in terms of training and compliance, which affects their decision on whether or not to participate in a voluntary inclusionary program or whether or not to build in a jurisdiction where it's mandatory.

Annual Reporting Montgomery County, MD

Every April, property owners must report the number of below-market units leased, residents' names, household size, dates of lease and lease expiration, total annual household income and a notarized statement that the residents meet the eligibility requirements to the best of the property owner's information. These requirements exemplify a streamlined process, breaking from more onerous federal requirements.

Source: Montgomery County, MD

Ensure the resident selection process does not make it difficult to lease inclusionary units. Identifying residents eligible to occupy the inclusionary units can add significant costs to owners and can delay filling a building if they are unable to find residents. To avoid this, resident screening requirements should be clear and easy to incorporate into the standard screening process. One best practice to reduce the costs of delay is for local governments to work with a nonprofit partner to identify a pool of eligible residents from which property owners can draw.

Inclusionary policies should maximize production by focusing on unit sizes and bedrooms, not finishes and materials. The size of a unit and the number of bedrooms are directly related to affordability, and an inclusionary policy can reasonably require that inclusionary units be comparable to market-rate units to maximize production. An effective inclusionary policy does not establish requirements about materials, location within the building, and access to amenities for inclusionary units. These are not issues related to affordability and can decrease the number of units a developer is able to deliver.

Resident Selection Montgomery County, MD

Basic resident eligibility requirements include gross income requirements, primary residency status, and not having owned residential property within the past five years. Prospective residents must complete a certification form and submit most recent federal tax returns, W-2s and pay stubs. Similar to annual reporting, these requirements are streamlined and do not default to more extensive federal requirements.

Source: Montgomery County, MD

Considerations & Limitations

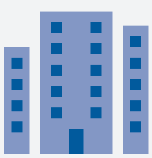
Before deciding to pursue an inclusionary housing policy, local governments should consider the limitations and benefits.

It can be very difficult to get an inclusionary zoning policy right. As this document explains, if the locality doesn't include the right incentives to offset the cost to comply with these programs, they can actually worsen their affordability challenges.

Local governments and the communities they serve should also have **realistic expectations about the number of inclusionary units and the level of affordability a policy will achieve.** The number of units produced by inclusionary policies is typically a small percentage of development in the area subject to the policy.

Few policies are effectively able to serve extremely low-income households because of the deep subsidy level required. **An inclusionary policy can be an effective component of a larger affordability strategy, but it will not be sufficient to address all affordability challenges of any community alone.**

Housing Goals



UNITS PRICED AFFORDABLY

MIXED-INCOME NEIGHBORHOODS

In implementing housing policies, local governments may pursue a range of housing goals. Properly structured inclusionary policies can be effective at **creating units with affordable rents and mixed-income neighborhoods,** but will not necessarily address racial segregation, displacement of existing residents, or other housing goals.

Impact

> **"Average annual production under local IZ programs varies across regions, but in all areas has contributed only a modest amount of affordable housing."**
>
> – Lance Freeman, Columbia University and Jenny Schuetz, Federal Reserve System

1 The White House (Obama Administration) Housing Affordability Toolkit, September 2016

Recommendations

To design an effective inclusionary policy, a city should take a four-tiered approach.

PROVIDE SUFFICIENT INCENTIVES: WITHOUT EFFICIENT INCENTIVES, INCLUSIONARY ZONING POLICIES CAN ACTUALLY REDUCE HOUSING AFFORDABILITY

- If incentives do not cover the gap between the below-market rents and market-rate rents, owners will either have to raise the rents for the market-rate units or cancel plans to develop the property altogether.
- Even modest rent reductions not recovered through incentives significantly reduce the financing a property can secure.
- The "cost" of an inclusionary policy to developers depends on how many below-market units are required and the allowable rent levels for those units.
- Collaborate with property managers, owners, and developers.
- Policymakers need as many incentive options at their disposal as possible to accommodate the diversity of their housing market needs.
- While density bonuses are the most common policy incentive used, they are not a panacea.

TARGET STRONG MARKETS: EFFECTIVE INCLUSIONARY POLICIES SHOULD TARGET STRONG HOUSING MARKETS AND VARY ACCORDING TO MARKET CONDITIONS

- "Areas not experiencing any or much market-rate development will likely not generate significant results from an IZ policy" – Urban Land Institute.
- Most cities do not have a strong enough housing market to support a citywide mandatory inclusionary policy.
- Citywide inclusionary policies should include different incentives and requirements for different neighborhoods.
- Inclusionary policies should be revaluated periodically.

OFFER FLEXIBILITY: EFFECTIVE INCLUSIONARY POLICIES OFFER FLEXIBILITY TO DEVELOPERS IN HOW THEY PARTICIPATE

- Mandatory inclusionary policies can harm affordability.
- Voluntary policies are less risky for affordability.
- Engaging developers is the best way to ensure the best outcome for stakeholders and policymakers.
- Include a payment in-lieu option.

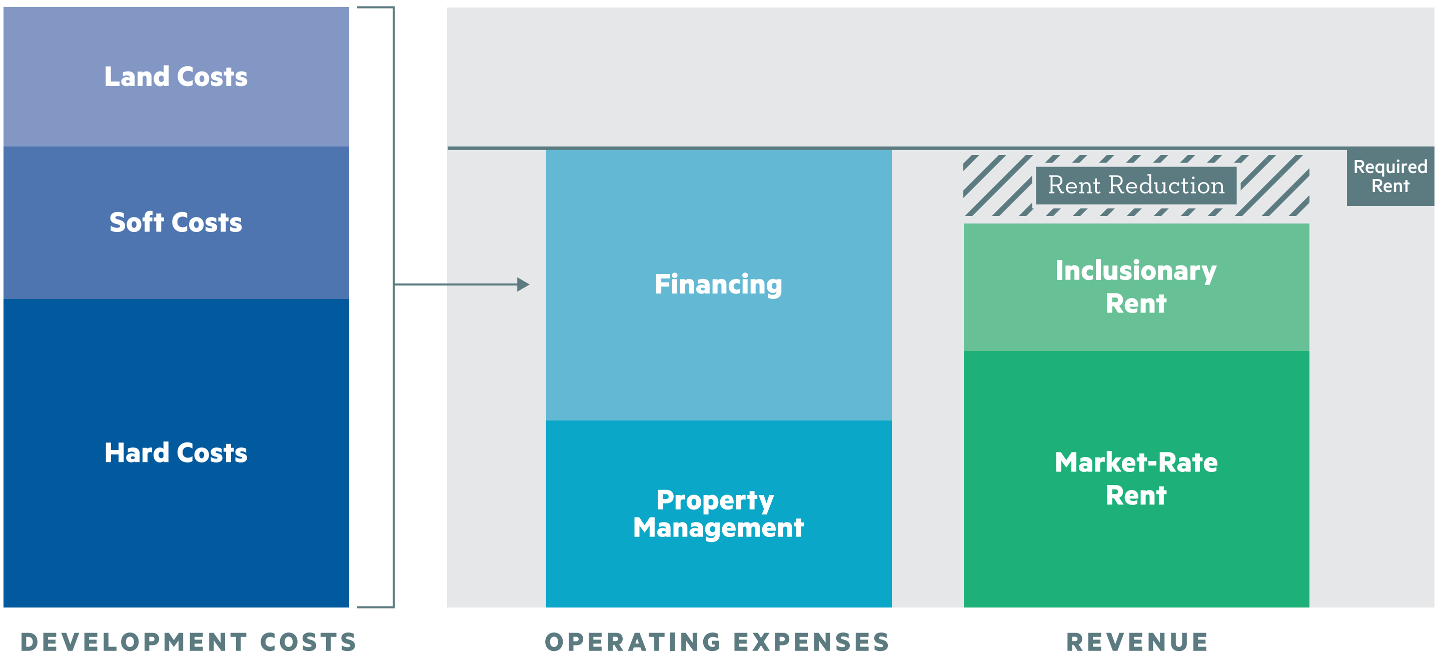
KEEP IT SIMPLE: INCLUSIONARY POLICIES THAT ARE SIMPLE TO COMPLY WITH ARE MORE EFFECTIVE

- Administratively complex programs harm affordability.
- Keep income documentation and reporting requirements simple. Don't default to burdensome federal requirements.
- Ensure the resident selection process does not make it difficult to lease inclusionary units.
- Inclusionary policies should maximize production by focusing on unit sizes and bedrooms, not finishes and materials.

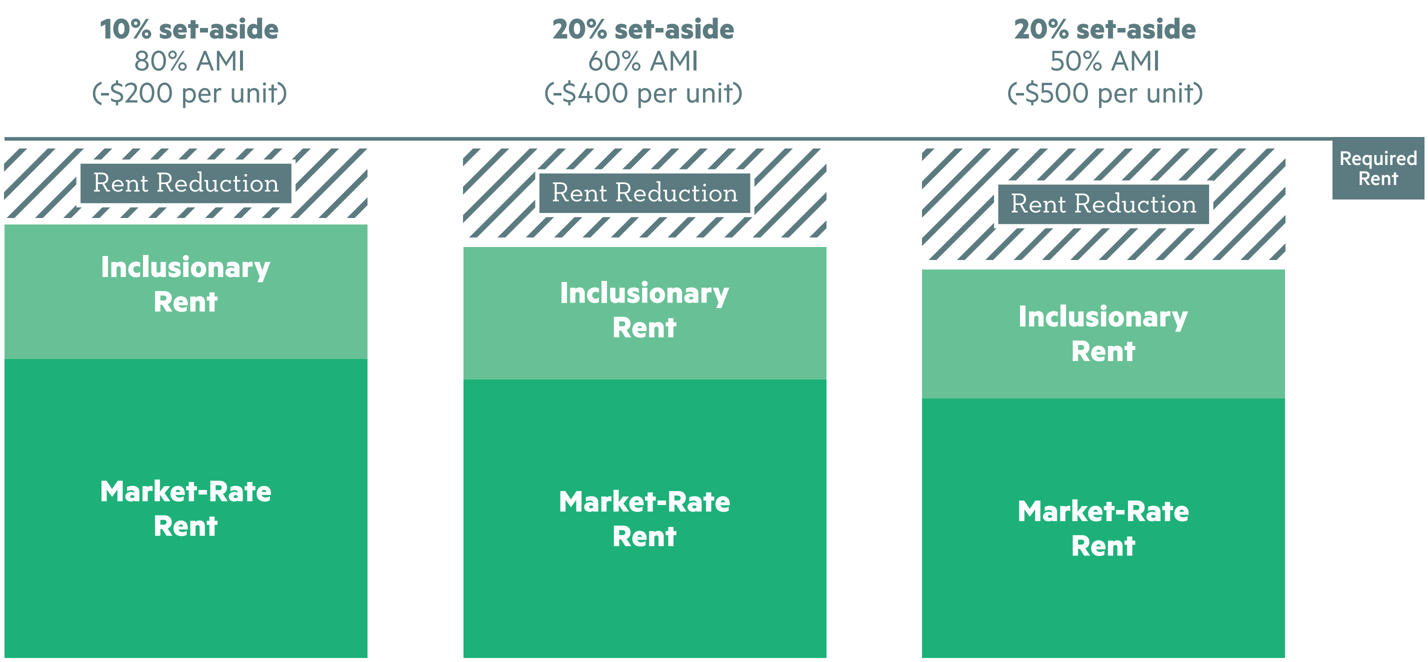
Economics of the Tool

Revenue from rent is reduced as affordability requirements are added.

The addition of inclusionary units in a new development introduces a gap in revenue. Without adequate revenue to cover expenses, a project becomes infeasible.



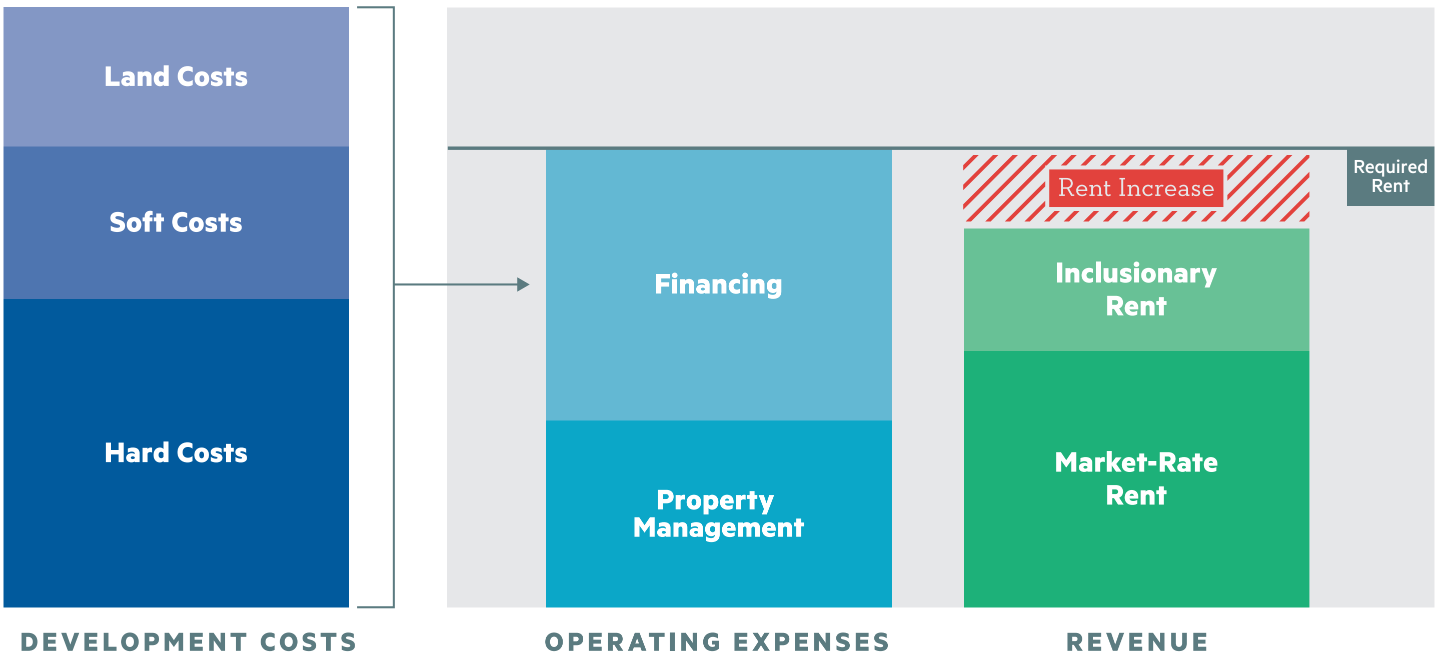
As affordability requirements deepen, the reduction in rent expands.



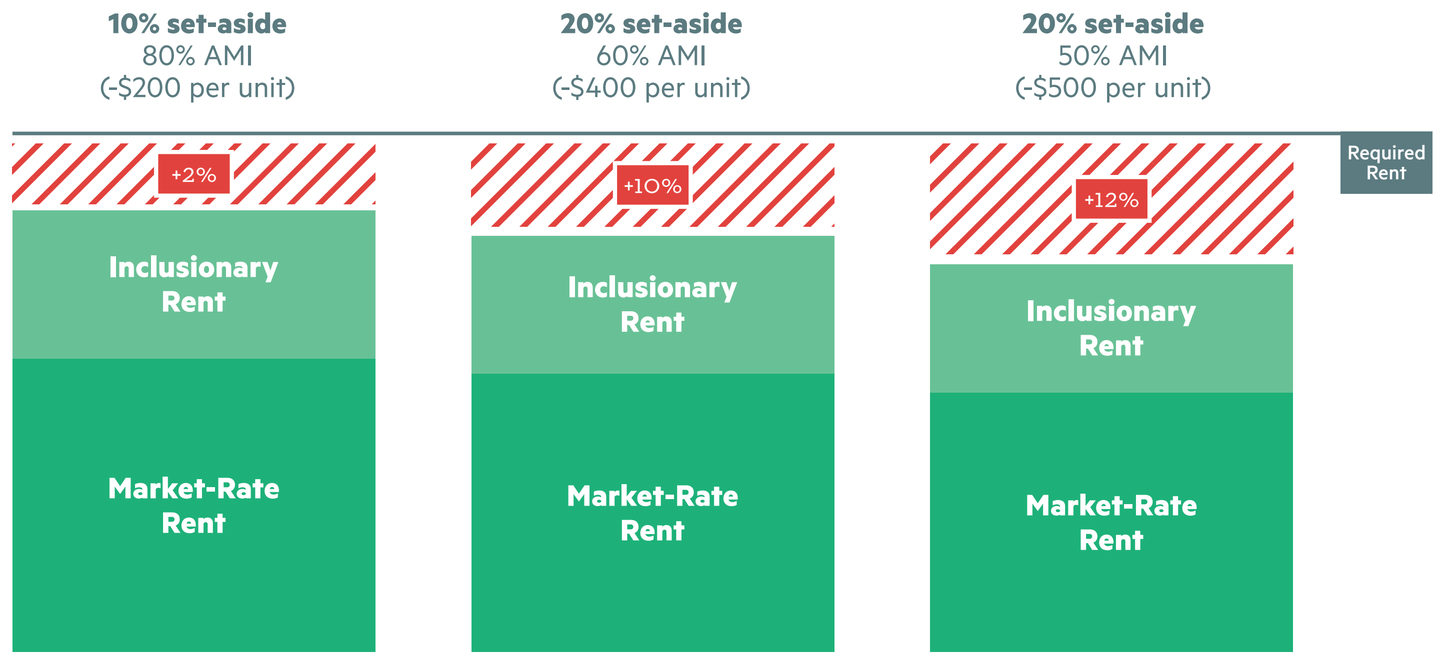
Economics of the Tool

Without incentives, market-rate rents must rise to offset the reduction in rent for inclusionary units.

Market-rate rents rise to cover the gap in revenue created by the affordability requirements.



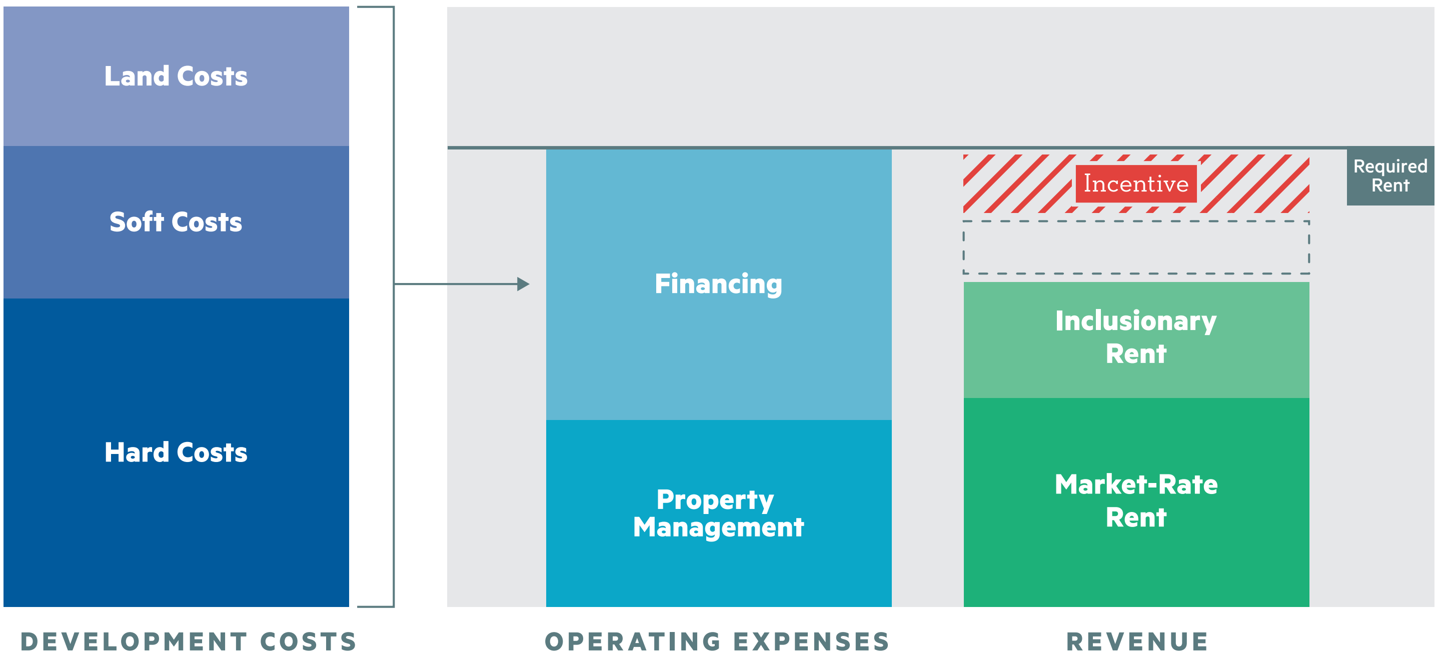
As affordability requirements deepen, the required rise in rent grows. If the market cannot support the increase, the project will not be built.



Economics of the Tool

Incentives can offset the reduction in rents from inclusionary requirements.

Jurisdictions can offer a variety of incentives to close the revenue gap. The incentives can lower development costs or operating expenses or increase the revenue earned from market-rate development.



If an incentive package addresses the gap created from rent reduction, market-rate rents will not rise.

If the incentives do not sufficiently fill the gap, market-rate rents will still rise, but to a lesser degree.