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Inclusionary Zoning: The Effect of Market Forces on Local Housing Law

John R. Nolon
Elisabeth Haub School of Law at Pace University, jnolon@law.pace.edu

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John R. Nolon

[John Nolon is a Professor at Pace University School of Law, Counsel to its Land Use Law Center, and Visiting Professor at Yale's School of Forestry and Environmental Studies. Rosemarie Noonan is the Executive Director of the Housing Action Council, a non-profit agency that advises developers and municipalities.]

Abstract: As the price of housing continues to rise in the New York metropolitan area, municipalities have begun creating inclusionary housing ordinances to ensure working families have a place to call home. This article analyzes the effects of inclusionary zoning ordinances on the economics of affordable housing and suggests several potential methods that local, state, and federal government may utilize to ease the financial burden on developers willing to construct affordable housing projects.

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I. Introduction

The increased interest in municipal governments in adopting inclusionary zoning laws is of critical importance to the economy of the New York region. On April 19, 2006, this column discussed the recent adoption of such a law by the City of New Rochelle. The New Rochelle law includes a 10% mandatory affordable housing requirement for certain residential projects built in the city and allows developers to make a monetary contribution to "buy out" of their obligation to provide affordable housing directly. Law and economics are intricately intertwined as evidenced by the efforts localities are making to legislate the creation of housing affordable to those who cannot afford the escalating price of housing in the New York metropolitan area. This column discusses those economics and their affect on the emerging field of inclusionary zoning law. It covers the economics of the region's housing market, the effect of those economics on employers, the economic realities of housing projects, and the need for flexibility in local housing laws to react to and accommodate those economics in a constantly changing marketplace.

II. Housing Costs and the Economy

The New York, New Jersey, and Connecticut metropolitan areas are experiencing the same crisis: high housing costs, increased need for more affordable housing, and low vacancy rates. These factors have negatively impacted the local economy and particularly its employers. The underlying reasons for the regional housing crises and the resulting toxic effect on the economy are varied and support the position that, "Housing is a regional issue that is critical to economic competitiveness. Employers make business location decisions based on the ability to attract a talented workforce, and our region's housing crises makes it increasingly difficult to attract and retain residents at all income levels."[1]

A balanced housing market where affordability, choice, and quality of housing are in harmony would attract and sustain employers and encourage economic growth for the New York region. The Metropolitan area (NY-NJ-CT) houses approximately 22 million people. More than nine million people commute within the region, and nearly half a million cross state lines to commute daily to work.[2] The Metropolitan region is the largest and most densely populated region in the United States. The region is known for its high housing prices and high wages; however, the average wages do not reflect the wide spectrum of wages within the region.

The National Low Income Housing Coalition "Out of Reach" 2005 report lists both New York State and the New York Metropolitan area in the top ten least affordable states and regions in the nation. The 2000 Census reports that 29% of New York Metropolitan area households are *cost burdened* and must pay more than 35% of income on housing. The problem is worse in suburban households than in the urban core. The percentage of cost burdened suburban households can reach up to 70% of households with earnings up to $19,000, and between 33% - 40% of suburban households are cost burdened with earnings between $20,000 - $49,999.[3]

What types of employees does the housing crisis effect? By way of example: police, firefighters, teachers, EMS workers, municipal employees, cooks, physical therapists, interpreters, coffee shop workers, librarians, tax preparers, teaching assistants, security and fire alarm installers, coaches, maids and housekeepers, bookkeepers and home appliance repairers.[4] Which industries are affected by the housing crisis? According to the New York State Department of Labor, employers affected includes manufacturing, construction, transportation and public utilities, wholesale and retail trade, finance and real estate, services, and federal, state, and local employers.[5]

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[1] Robert D. Yaro, President of Regional Plan Association (in a press release dated 5.17.04).

[2] Citizens Housing & Planning Council (CHPC*) "Out of Balance: The Housing Crises from a Regional Perspective"* (April 2004).

[3] Presentation to the North East Planners Conference *"Out of Balance: The Housing Crisis from a Regional Perspective"* (May 2004).

[4] Bureau of Labor Statistics

[5] NYS Department of Labor

The following economic consequences logically flow from the regional housing crisis:

- All employers are faced with increased challenges to recruit and retain staff due to increasing cost of housing and reduced production of new affordable units. This may require employers to offer higher salaries or a sign-on bonus to fill positions which smaller companies, government agencies, and non-profits may be unable to offer.
- High employee turnover causes a lack of company loyalty, inefficiency in the workplace, and additional training costs.
- Lengthy commutes lead to employee tardiness, employee absences, fatigue, decreased productivity, negative impact on families, increased air pollution, clogged traffic arteries due to heavy commutes in and out of the core area, increased automotive repair expenses, increased dependence on foreign oil, and increased costs for road improvements.

In a 2000 Report concerning the shortage of affordable housing and how it impacts the New York City economy, the New York State Comptroller's Office noted that, "A major strategic link to economic development, however, remains largely neglected –housing. In the long term, the high cost of housing may well have negative implications both for job growth and for the quality of the workforce that is essential to attracting businesses to New York City. Our research strongly suggests that New York City's inadequate supply of quality affordable housing serves to limit the City's prospects for long-term economic growth."[6]

The lack of affordable housing is causing employers to consider and adopt a number of initiatives including raising salaries; offering down payment assistance, grants, or loans; adopting ride sharing arrangements; contributing funds to housing development or advocacy organizations; and developing employer assisted housing programs.[7] Businesses generally do not create new affordable units for employees.

III. Housing Economics & Inclusionary Zoning

In an effort to stimulate the creation of more affordable units to house its local workforce and others, several local municipalities have adopted zoning laws to address the affordable housing shortage by mandating an inclusion of affordable units in new construction or offering zoning incentives to create new affordable units. Affordable zoning compliance can have a benign or detrimental effect on a development proposal depending on land costs, market prices, construction and financing costs, and swings from a seller's to a buyer's market.

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[6] State of New York Office of the Deputy Comptroller for the City of New York *"No room for Growth: Affordable Housing and Economic Development in New York City*" (August 2000).
[7] The Westchester Public Issues Institute, "*The High Cost of Housing: A Survey of Employers & Employees in Westchester County"* (April 2002).

In Westchester County, inclusionary zoning has been used as a legislative tool in ten municipalities mandating the creation of affordable units in conjunction with market rate proposals by requiring that a fixed percentage of units be developed as affordable units in selected districts or community wide. In New York City, inclusionary zoning is primarily incentive-based rather than mandatory. In response to the strength of the residential market in recent years the City encourages the creation of affordable housing during rezoning applications. The City permits the development of more units than could otherwise have been developed provided that an affordable component is developed as well. The City's approach is more flexible and becomes an attractive incentive to developers to maximize development of the site by creating affordable units on-site. This approach is triggered by the developer and may be driven by changes in the market.

The question arises as to whether mandatory set-aside zoning, such as has been adopted in ten Westchester municipalities, is sensitive to changes and fluctuations in the market. The rising cost of land, interest rates, and development costs factor into the financial feasibility of creating affordable units on site. These variables could work against the feasibility of a development proposal by requiring substantial subsidies to cover the differential between the cost to develop an affordable unit and the restricted price of an affordable unit to the purchaser or renter.

The following chart is illustrative of the cost of developing modest one- and two-bedroom units in Westchester County as compared to sales prices affordable to households whose income is at 80% of the County median income, and the gap between development costs and sale prices. The example assumes no land costs.

Cost of Housing Development/Affordable Price Gap

	2 Bedroom
Size of Unit (SF)	1,000
Size of Household (# of Persons)	2
Construction Cost ($185/SF)	$185,000
Soft Costs (20%)	37,000
Developer Fee (15%)	33,300
Contingency (5%)	12,765
Reserves & Working Capital (2%)	5,361
TOTAL Development Cost	**$273,426**

Ownership	
Household Income @ 80% of Median	**$61,750**
Affordable Housing Payment @ 30%	1,544
Real Estate Taxes	350
Condo Fee	350
Net Available for Mortgage	844
Affordable Mortgage @ 6.5%)	133,490
Downpayment (3%)	4,129
Affordable Price	**137,619**
GAP	**$135,807**

The question also arises whether the requirement to construct affordable housing units within a market rate project will discourage development. Will the developer absorb the cost of developing affordable housing, i.e., will he or she internally cover the gap between the development cost of the affordable unit and its sale price? Will the developer accept a lesser return on his or her investment or will he or she view it as a cost of doing business? Or will the municipality need to offer incentives, such as density bonuses, tax abatement, or financial assistance, to induce developers to build within their communities with an affordable housing component? A recent modeling exercise of the impact of a specific affordable housing ordinance on a developer's profit showed an average reduction in profit of 5%.

The following list illustrates financial aids that may be available to soften the economic impact of an affordable housing set-aside requirement:

Financial Assistance for Inclusionary Zoning

- Infrastructure Grants
- Reduced Real Estate Taxes
- Exemption from Mortgage Taxes, Sales Taxes & Transfer Taxes
- Downpayment Assistance
- Tax Credits
- Capital Grants
- Favorable Financing Terms

Infrastructure Grants: Westchester County's Housing Implementation Program provides grants to cover the cost of public improvements associated with the development of affordable housing. A two-family development in Yonkers with market rate and affordable housing accessed funding to cover a portion of the costs of the parking lot, sewer connections, sidewalks, and street lighting.

Reduced Real Estate Taxes: Over the years, New York City ordinances have provided structured tax abatements in return for particular types of development. In other communities, tax abatement is negotiated and is referred to as a PILOT (Payment in Lieu of Taxes) Agreement. State law guides tax assessors on favorable treatment of projects which involve an affordable rental component.

Exemption from Mortgage Taxes, Sales Taxes & Transfer Taxes: Financing through industrial development authorities or developing through not-for-profit and limited profit agencies formed pursuant to the NYS Private Housing Finance Law provides bases for various exemptions from taxes.

Downpayment Assistance: Among the variety of federal, state, and local programs that provide downpayment assistance to eligible buyers are the New York State Affordable Housing Corporation and the federal American Dream Downpayment Initiative.

Tax Credits: Income tax credits are available for the construction of rental units affordable to households with incomes at or less than 60% of the area median income. St. James Gardens, a 62 unit mixed income rental housing development in Yonkers, made use of this financial aid.

Capital Grants: Federal, state, local, and private agencies provide funding for construction costs, including the NYS Housing Trust Fund Corporation, Empire State Development Authority, and the Federal Home Loan Bank.

Favorable Financing Terms: Most major financial institutions have community development lending units with particular expertise and products for affordable housing. Entities such as the NYS Housing Finance Agency and Industrial Development Authorities provide tax-exempt financing. The Federal Home Loan Bank offers a Community Investment Program (CIP) product through its member banks.

A “buy-out” approach to inclusionary zoning must also take housing economics into account. In two Westchester County cities (White Plains and New Rochelle) “buy-out” provisions were incorporated into the zoning, whereby a developer may, under certain circumstances, pay a fee into an affordable housing fund, in lieu of creating units on site or elsewhere. The municipality must calculate an appropriate and fair buy out fee, which is financially justifiable. The buy-out fee schedule should not be so burdensome as to prevent developers from receiving a reasonable return on their investments, and conversely, not so low as a token fee that cannot create the undeveloped affordable units elsewhere. In White Plains’ 6% set aside requirement, the buy-out is $67,000, $115,000, and $155,000 for a one, two, and three bedroom apartment respectively.

Other flexible options to address housing economics may be to provide discretionary zoning incentives layered on top of, or in lieu of, inclusionary zoning, such as a density bonus which will permit additional market units to be developed if the affordable units are created on-site. This device can act as an internal crossover subsidy to enable the developer to finance the affordable units internally in a fluctuating economic and real estate market by permitting more market rate units on site.

In several suburban communities buy-out fees have been expanded beyond multi-family development to single-family construction. In several communities, subdivision applications may be required to include affordable units. For example, in the Town of Huntington, Suffolk County, as part of subdivision applications in selected districts, once the affordable housing obligation is calculated, 10% of the affordable housing obligation must be developed on-site within the subdivision. In lieu of providing the remaining 10% of the obligation, the developer may choose to pay a fee into a Housing Trust Fund. The fees per lot range from $75,000 to $200,000, depending on the zoning district.

IV. Housing Law Formulation

There is clearly a need for housing for the local workforce and others. As evidenced by the growing number of inclusionary zoning ordinances, there is a municipal desire to create housing that is affordable to these groups and tap into market rate developments to produce the housing. This approach requires attention to housing economics, including: market demand, interest rates, construction costs, and rates of return on investments and their change. It requires a balancing of the developer's economic interest and the municipality's interest in creating modestly priced housing. This applies whether a mandatory inclusionary, incentive-based ordinance, or a buy-out is used. A flexible approach to application of the ordinance is also needed.

Questions to explore as inclusionary zoning ordinances are developed and/or modified include:

- Will a set-aside requirement and/or buy-out on its own deter development? Related to this are market demand and development costs. Will the development community accept such requirements as a general cost of doing business?
- Are incentives needed to assure the development of modestly priced units? If so, what levels of incentives are needed, enough to bridge the gap between the cost of producing and the sale or rental price of the affordable units, or an incentive that assures a greater return?

- Should a buy-out be permitted? Under what circumstances and should it be developer initiated or subject to the approval of the municipality?
- Will a buy-out accomplish the creation of affordable units?
- How can flexibility be built into an ordinance to adequately respond to changing economic conditions?