BIA Greater Valley

Building Industry Association of the Greater Valley
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September 3, 2021

Mayor Serratto
City of Merced
678 West 18th Street
Merced, CA 95340

Mayor Serratto and Council:

Re: Public Comment Item J1

Due to the recent discussions by the City Councils in Tracy and Merced pursuing the concept of Inclusionary Zoning (IZ) policies the BIA in conjunction with the California Homebuilding Foundation commissioned a study through Point Loma Nazarene University to thoroughly examine IZ in the Central Valley.

Fortunately, that study has just been completed in time for your review in conjunction with your ongoing housing policy discussions. The study contains some additional recommendations for your consideration apart from IZ.

The BIA is supportive of the staff direction as presented in the staff report and presentation regarding housing. We remain committed to assisting you in guiding housing policy for the city and helping all citizens obtain housing and maintaining a high quality of life.

Sincerely,

John R. Beckman
Chief Executive Officer

INCLUSIONARY HOUSING POLICIES IN THE CENTRAL VALLEY: COSTS VS. BENEFITS

2021

Prepared By:
The Fermanian Business & Economic Institute

California Homebuilding Foundation®
Scholarship | Research | Education

BIA Greater Valley

About the California Homebuilding Association

CHF's mission is to advance the homebuilding industry in California by providing scholarships, publishing innovative research findings, and promoting workforce education programs.

CHF is a 501(c)3 nonprofit organization. Federal Tax I.D. 94-2581819.

Every dollar donated in support of the Foundation represents a donor's legacy and a dream for lasting change.

About the Fermanian Business and Economic Institute (FBEI)

The FBEI specializes in providing business and economic consulting services to for-profit and non-profit companies, individuals, organizations, government entities, and others throughout the San Diego region and California, as well as nationally and internationally. Consulting services include economic analysis, forecasting, economic impact studies, business plans, market research, and feasibility studies.

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Some data in this report was obtained from The Construction Industry Research Board (CIRB), a service provided by the California Homebuilding Foundation (CHF). CIRB data offers valuable insight into the health and activity of the building industry in California. Monthly statewide reports provide residential and non-residential construction permit statistics for all California counties and reporting cities within. For more information on monthly subscriptions or custom reports, please contact Joe Sanchez at (916) 340-3340 or chf-cirb@mychf.org or visit the CIRB website at http://www.cirbreport.org

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EXECUTIVE SUMMARY

Housing has increasingly become a key issue facing Central Valley residents, businesses, and policymakers. Escalating prices and rents reflect the inadequacy of supply troubling communities throughout California. Two housing concepts are at stake:

1. Affordable housing and
2. Housing affordability.

Affordable housing refers to housing produced for lower income households usually at subsidized or below-market rates. Housing affordability refers to the ability of the general population to afford to rent or buy a home without undue financial hardship or special assistance.

This study evaluates the potential impact of an inclusionary zoning (IZ) policy in the region requiring that builders and developers set aside either 5% or 15% of their units for lower income households or those earning 80% or less than the average median income (AMI). It examines the potential impact on the cities of Merced and Tracy. Merced began considering an IZ policy in February 2021 and Tracy might also consider the option.

Two Central Valley cities have implemented IZ policies over the past two decades. Patterson launched a 10% IZ policy in 1995, which was increased to 15% in 2013. Ripon has maintained a 5% IZ since 2001. Relative to their base populations, both cities have seen smaller increases in housing production in the period since 2010 than cities without IZ policies. Patterson's higher 15% IZ requirement appears to have affected homebuilding especially adversely. The City's housing stock growth has underperformed that of neighboring cities, and it has created fewer homes for each new resident.

An analysis of the potential impact of a new IZ policy for the cities of Merced and Tracy found the following:

Merced

5% IZ

» A 5% IZ requirement would push new home prices up 4.8% and boost rents on new apartments by 4.2%.
» A 5% IZ would reduce the total production of new for-sale and rental new housing by 4.7%. Although there would be an addition of 35 affordable units, there would be a decrease of 68 market-rate units.
» For each rental or for-sale home produced for a lower income household, 2.0 other households would no longer be able to afford new housing in the marketplace.

5% IZ Policy Effects on Total Housing
City of Merced

City of Merced Total	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	725	691	-34	-4.7
Affordable housing (AH)	0	35	35	NA
Market Housing	725	657	-68	-9.4
Change in MktH/AH, No. HH	NA	NA	-2.0	NA

SOURCE: CIRB, FBEI

15% IZ

Under a 15% IZ policy,

» New home prices would rise 8.1% to $378,000 from $350,000. Monthly rents would surge 9.5%, or $133 per month, to an average of $1,533.
» Total housing production would fall a sharp 22%.
» For every additional affordable unit produced, 2.8 market rate units would be lost.

15% IZ Policy Effects on Total Housing City of Merced

City of Merced Total	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	725	568	-157	-22
Affordable housing (AH)	0	85	85	NA
Market Housing	725	483	-242	-33
Change in MktH/AH, No. HH	NA	NA	-2.8	NA

SOURCE: CIRB, FBEI

Tracy

5% IZ

» A 5% IZ regulation would raise new home prices by 4.2% and increase monthly rents by 4.3%.
» A 5% IZ regulation would decrease the total production of new for-sale and rental new housing by 6.1%. Although there would be an addition of 44 affordable units, there would be a decrease of 101 market-rate units.
» For each rental or for-sale home produced for a lower income household, 2.3 other households would lose access to new housing in the marketplace.

5% IZ Policy Effects on Total Housing City of Tracy

City of Tracy Total	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	935	878	-57	-6.1
Affordable housing (AH)	0	44	44	NA
Market Housing	935	834	-101	-11
Change in MktH/AH, No. HH	NA	NA	-2.3	NA

SOURCE: CIRB, FBEI

15% IZ

Under a 15% IZ policy,

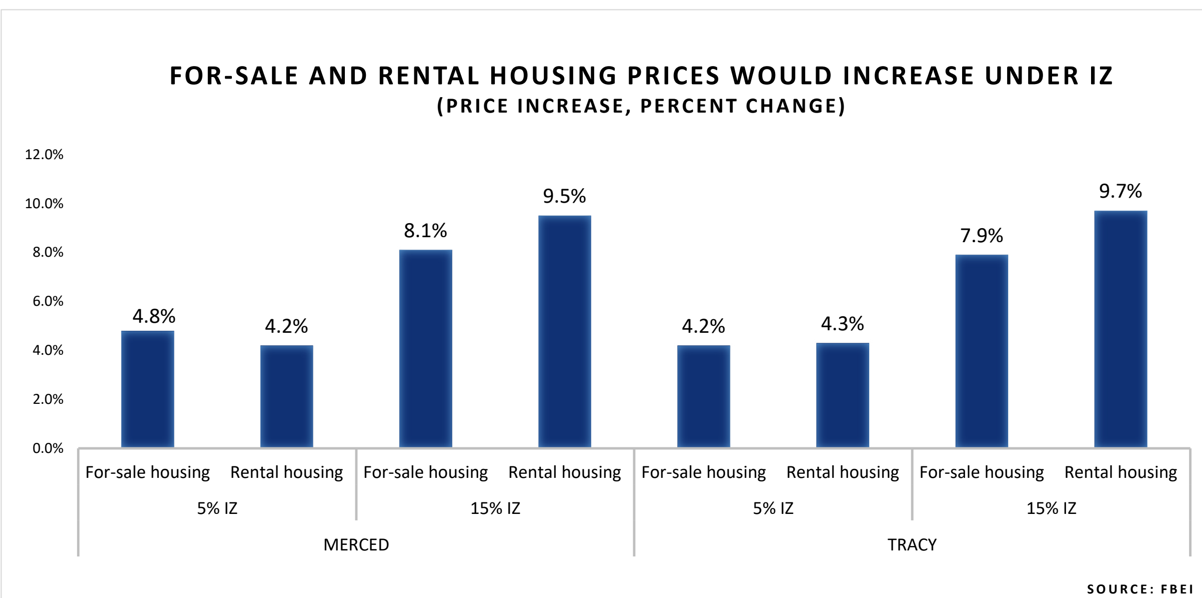
- New home prices would jump 7.9% from $700,000 to $755,000. Rents would climb 9.7%, or $310 per month, to an average of $3,510.
- Total housing production would drop a steep 23%.
- For every additional affordable unit produced, 2.9 market rate units would be lost

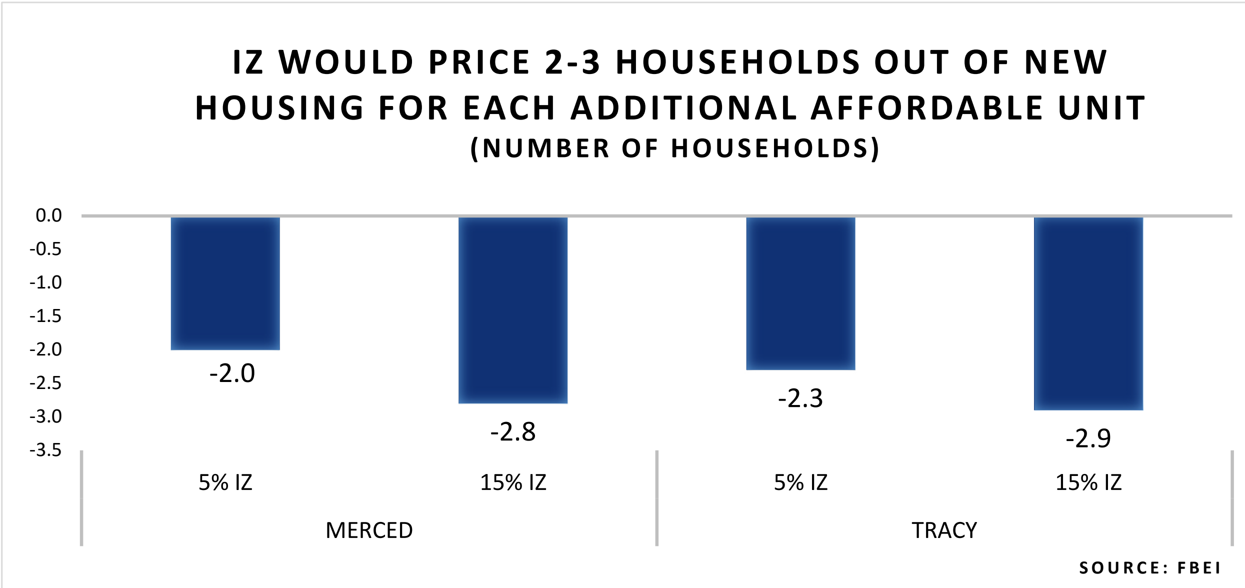
15% IZ Policy Effects on Total Housing
City of Tracy

City of Tracy Total	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	935	725	-210	-23
Affordable housing (AH)	0	109	109	NA
Market Housing	935	616	-319	-34
Change in MktH/AH, No. HH	NA	NA	-2.9	NA

SOURCE: CIRB, FBEI

The results for the two cities show that a 15% IZ would trigger rising home prices and rents, declining affordability, and the construction of fewer homes when more are needed.





The study's findings highlight a critical question facing policymakers: Is providing additional affordable housing for a few worth the substantial further deterioration in housing affordability for the rest? The study shows the size of the tradeoff. For every household fortunate enough to access an affordable unit, two to three households would be forced out of the new housing market.

If policymakers decide that more affordable units should be produced in their cities, they need to decide who should be responsible: homebuilders, employers, or taxpayers. Barriers to homebuilding should be carefully evaluated. The least costly solutions would involve reducing the amount of time involved in project reviews, approvals, and monitoring.

In pursuing a public financing option, analysis of recent policies in Seattle, Salt Lake City, and San Francisco indicates the value of a consistent and dedicated revenue source for raising the number of affordable housing units. These funds could be combined with grants, tax exemptions, tax credits, and low-interest loans to raise the number of affordable units without compromising or decreasing the availability of middle income or workforce housing. This would appear to be a much more productive and positive approach than an IZ policy that imposes more costs than benefits.

INTRODUCTION AND STUDY PURPOSE

HOUSING IN THE CENTRAL VALLEY

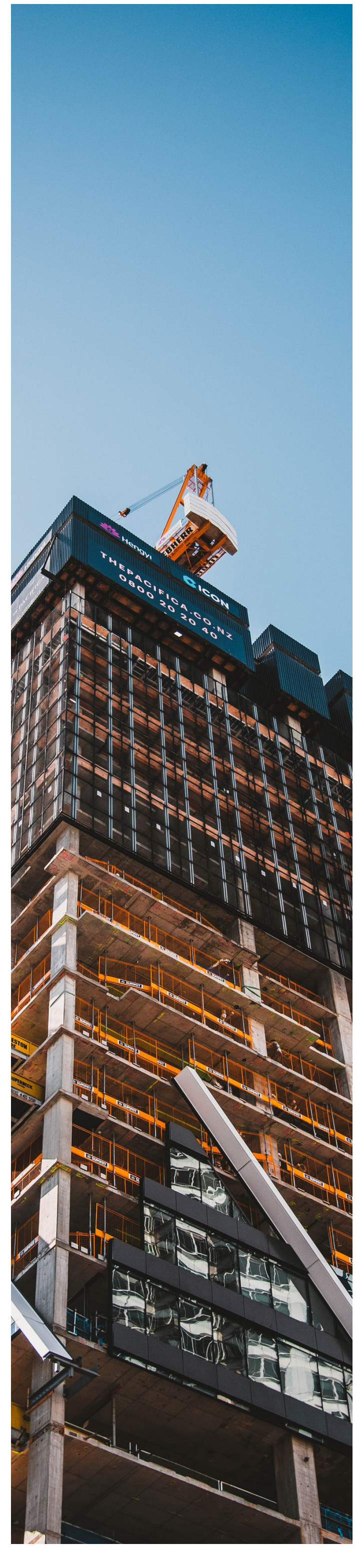
Housing remains a major barrier to the Central Valley's growth, with the region's residents and employers struggling with the same issues facing other Californians. As the region recovers from the impact of Covid-19 and deals with the further disruptions of the Delta variant, rising home prices and rents continue to outstrip incomes. Low interest rates, increased remote working, and demand for more space have fueled demand. New construction has struggled to keep pace, hampered by a surge in materials costs and difficulties in staffing construction jobs.

The latest housing pressures add to those that have been accumulating over the past two decades. Agribusiness and other sectors have driven a continuous demand for workforce housing. Significant pressure from San Francisco Bay Area workers looking for less expensive space has fueled demand in such cities as Tracy in San Joaquin County. Land use constraints, environmental considerations, and various government policies have limited the supply response even while other goals may have justified their use.

Housing access has emerged as a top concern for both the region's households and employers. Policymakers face two critical issues: affordable housing and housing affordability. The two concepts are distinct and frequently conflict.

> Affordable Housing: The provision of homes or apartments for households typically earning less than the area's average median income (AMI).
>
> Housing Affordability: The ability of the general population to access housing at a price that does not cause extreme financial stress, including large debt burdens

If actions focused on boosting affordable housing raise the price of market housing, policymakers may be disappointed to see the decline in overall housing affordability.



HOUSING POLICIES IN THE CENTRAL VALLEY

Patterson has maintained an inclusionary housing policy (IZ) since 1995 requiring that builders set aside 10% (changed to 15% in 2013) of their units for lower or moderate income households or pay an in lieu fee. Ripon launched its 5% IZ, with an in lieu option, in 2001.

Neither the City of Merced nor Tracy has ever implemented an IZ regulation, but in February 2021, Merced's City Council began considering the option.[1] Tracy could at some point also consider an IZ policy.

[1] Scrivner, A.L. (2021, May 3). Would inclusionary zoning mean more affordable housing for Merced? City leaders divided. Merced Sun-Star.

STUDY PURPOSE

This study seeks to answer three major questions:

» How have affordable housing policies implemented in the cities of Patterson and Ripon performed since they were launched more than twenty years ago? How have the requirements affected these cities' housing production?

» How would inclusionary zoning policies affect the housing outlook in the cities of Merced and Tracy? What trade-offs would occur between possible costs and benefits?

» What housing policies should government leaders consider to achieve more affordable housing for their lowest income households and also more affordable workforce housing?

Patterson's and Ripon's experience will be analyzed in terms of the impact on the total housing stock, permit issuance for new developments, the ability to keep pace with population gains, and the creation of affordable units.

The potential costs and benefits of IZ policies on the cities of Merced and Tracy will be modeled to understand the expected impact on home prices, rents, total housing production, and affordability in both the for-sale and rental markets.

Past and projected experience with affordable housing policies in the Central Valley will combine with other research to provide policymakers with recommended housing solutions to pursue.

INCLUSIONARY ZONING POLICY RESULTS IN THE CENTRAL VALLEY

Few areas have implemented affordable housing policies in the Central Valley, but two cities offer insights on the effects of inclusionary zoning (IZ) requirements. The city of Patterson started its mandatory IZ polices in 1995, while the city of Ripon launched its IZ requirements in 2001.

POLICY SUMMARY

City of Patterson

The city of Patterson passed an inclusionary zoning ordinance in 1995 requiring that 5% of new housing units be made available to low or very low-income households and another 5% of new units be made available to moderate income households. In 2013, the ordinance was revised to require 15% of new housing be provided for very low, low, and moderate-income levels.

The law requires that, for owner-occupied units, 60% of affordable units must be made available to moderate income buyers and the remaining 40% of affordable units must be made available to low-income buyers. For rental units, 60% of affordable units must be made available to low- income renters and the remaining 40% of affordable units must be made available to very low- income renters. Since the ordinance's inception, an in-lieu fee option has been available to builders, which typically is the route they select.

City of Ripon

The city of Ripon passed an ordinance in 2001 giving builders three options to satisfy the affordable housing requirement. The first option requires 10% of the total units within a residential development project to meet FHA lending limits for San Joaquin County and the builder is required to pay the city of Ripon an Affordable Housing Fee. The second option is a 5% inclusionary zoning option, where 5% of new housing units are made available to low or moderate-income households. If a builder chooses this option, 75% of the affordable units must be made available to moderate-income households and 25% of affordable units must be made available at low-income levels. The third option is to negotiate how the builder may meet the affordable housing requirement, which may include payment of an in-lieu fee, dedication of vacant land, production of off-site affordable units, or conversion of existing market-rate units to affordable units.

Based on statements and information contained in the City's housing element, there are indications that the 2007-14 period may have involved a less aggressive enforcement of IZ regulations. Specifically, the housing element states, "During the 2007 through 2014 Housing Element cycle, the City suspended the BMR (below-market rate) program which resulted in a reduction in lower and moderate income units."

BUILDER EXPERIENCE

Most builders have chosen to pay the in lieu fee rather than build affordable units because of the costs and complexities of incorporating 5-15% below-market-rate (BMR) units in their projects. Most builders also lack the particular expertise required for the design and construction of BMR housing.

One builder's experience in trying to comply with Ripon's IZ requirement illustrates the regulation's costs and complexity. The company was planning to build on 127 lots in a single-family detached subdivision. It agreed with the City to set aside 6 lots for 12 duet affordable housing units. However, the builder did not have a duet affordable housing unit product and the time and expense of drafting architectural plans and gaining City approval for just 12 units would have been cost prohibitive. Ultimately, the builder arranged for another firm to construct the affordable units and the builder lost the value of the 6 lots.

The experience illustrates the negative effects that IZ policies can have in disrupting the economies of scale that act to hold down housing costs.

HOUSING POLICIES AND EFFECTS ACROSS THE CENTRAL VALLEY

Because Patterson launched an IZ policy in 1995 and Ripon one in 2001, considerable data exists to assess their performance. Although both cities have allowed an in lieu fee, the requirement still represents a tax on new building that raises the cost of new housing. In contrast, the cities of Tracy and Merced have proceeded without affordable housing or IZ regulations.

What does the data show about the housing experience of these four cities?

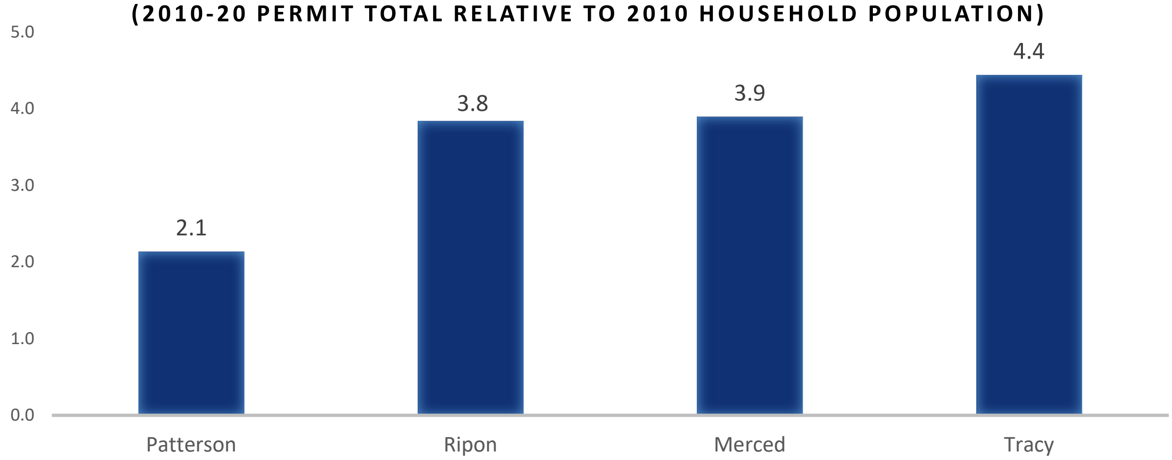
City Homebuilding Comparisons

Patterson's and Ripon's experience with IZ regulations over the past two decades appears to have adversely affected housing production relative to the experience of Merced and Tracy.

With a 15% IZ over most of the 2010-21 period, Patterson has generated the lowest number of housing permits relative to its base population. Although Ripon's lower 5% IZ has yielded more housing units relative to its population than Patterson, both Merced and Tracy have seen higher rates of homebuilding.

EXHIBIT 1

PATTERSON SHOWS LOWEST HOUSING PRODUCTION/BASE
(2010-20 PERMIT TOTAL RELATIVE TO 2010 HOUSEHOLD POPULATION)



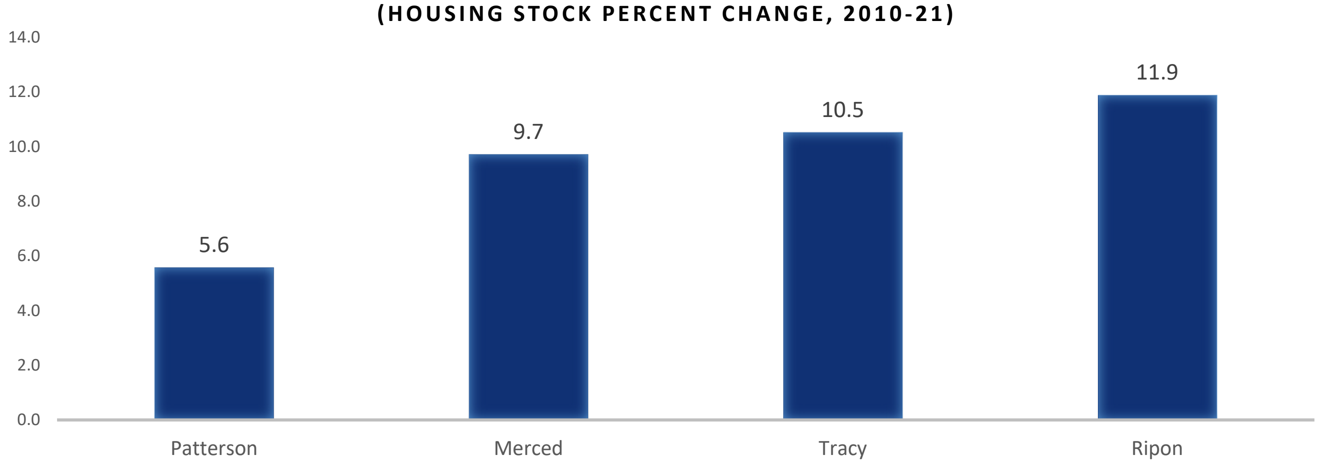
SOURCE: CIRB, FBEI

Patterson's overall housing stock growth has trailed that of key Central Valley cities. Between the beginning of 2010 and 2021, Patterson's total housing stock, which reflects the impact of both new additions and demolitions, climbed 5.6%. This was only about one-half the pace of the other cities in the region. Ripon, with a lower IZ that was not always strictly enforced, yielded a housing stock growth that was not significantly different from that posted by Tracy and Merced.

EXHIBIT 2

IZ POLICIES CONSTRAINS PATTERSON'S HOUSING STOCK GROWTH

(HOUSING STOCK PERCENT CHANGE, 2010-21)



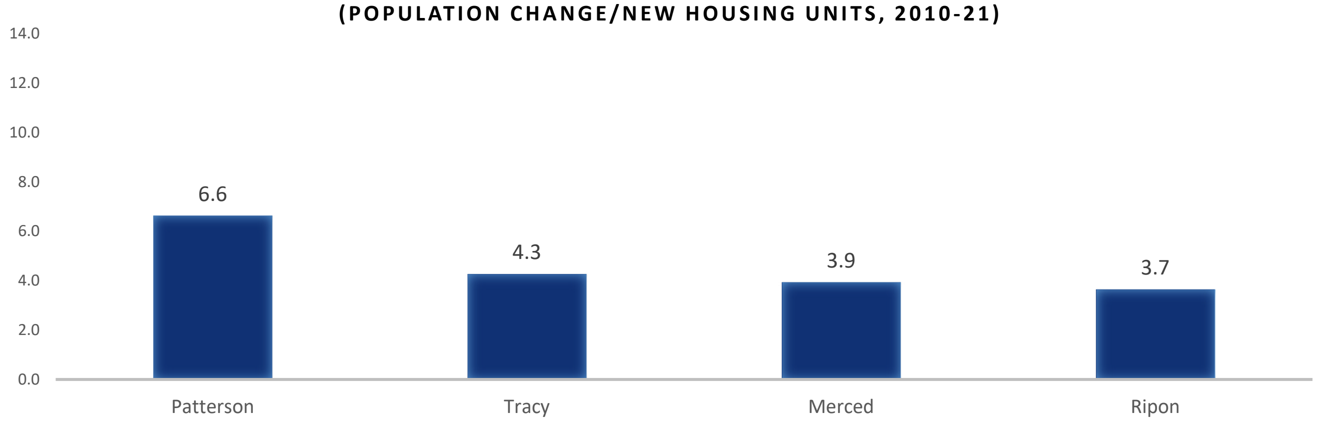
SOURCE: CIRB, FBEI

How effective were the four cities in accommodating population increases with new housing? Data from 2010-2021 again show that Patterson's 15% affordable housing regulations resulted in fewer new housing units per new resident than the other three cities. Over this period, only one new housing permit was issued for every 6-7 residents in Patterson. In the other three cities, an additional housing unit was added for every 4 residents.

EXHIBIT 3

PATTERSON ONLY BUILDING ONE UNIT FOR EACH 6-7 NEW RESIDENTS

(POPULATION CHANGE/NEW HOUSING UNITS, 2010-21)

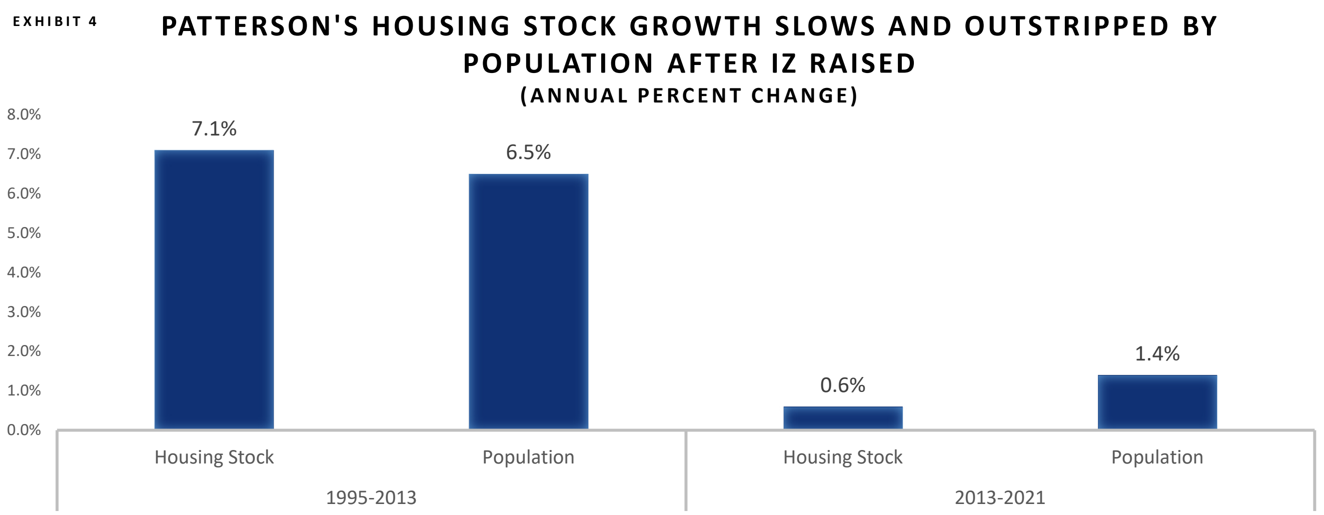


SOURCE: CIRB, FBEI

Patterson's and Ripon's IZ Results

Patterson's shift from a 10% total IZ to 15% requirement in 2013 appears to have affected homebuilding activity as the change further raised builders' costs. In the 1995-2013 period with a 10% IZ, the City's housing stock advanced an average 7.1% per year, outstripping the annual 6.5% population increase. In contrast, the 2013-2021 period, which contained a 15% IZ, saw annual housing stock growth slow to 0.6%, which trailed the average annual 1.4% population gain.

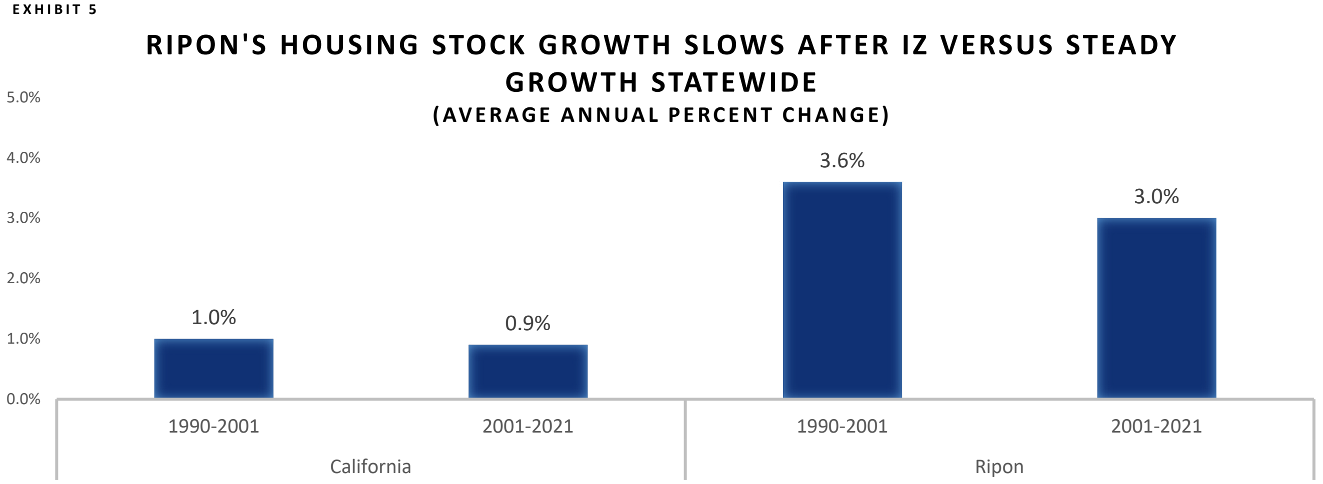
EXHIBIT 4



SOURCE: CA DEPARTMENT OF FINANCE, FBEI

Ripon's affordable housing policies may have also constrained some of its potential housing growth. In the 1990-2001 period, before the regulations were adopted, Ripon's housing stock advanced at an average of 3.6% per year. Since the 5% IZ policy was implemented, the City's housing stock growth has slowed to 3.0% per year. In contrast, California overall has seen little change in its annual average housing stock growth, which has held steady at about 1.0% per year.

EXHIBIT 5



SOURCE: CA DEPARTMENT OF FINANCE, FBEI

Affordable Housing Effects

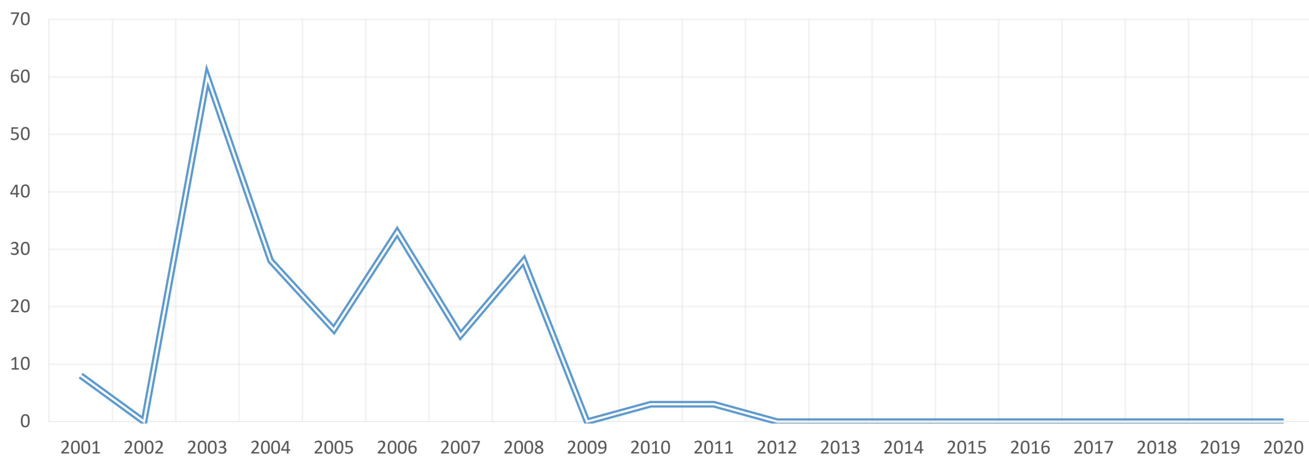
California now requires local areas to establish goals for overall housing production and planning for the creation of units of lower and moderate-income housing. These are part of the Housing Element reports filed with the State.

Ripon's data highlights the weak performance of affordable housing programs. Over the entire span of the program, starting in 2001, few units designated for very low, low, and moderate-income households have been produced. Total income-restricted units produced over this period have summed to just 194 units. Production of these units was also highly concentrated in the 2003-08 period, when general homebuilding was surging.[2]

EXHIBIT 6

IZ PRODUCES LITTLE AFFORDABLE HOUSING IN RIPON

(NUMBER OF LOWER AND MODERATE INCOME UNITS)



SOURCE: RIPON HOUSING ELEMENT, FBEI

Many forces have affected the Central Valley's housing production over the past two decades, including the housing bubble of the mid-2000s, the Great Recession, lending standard changes, interest rate swings, and COVID-19. Affordable housing policies also have affected homebuilding. The additional requirements and costs imposed by Patterson's and Ripon's IZ ordinances appear to have adversely affected homebuilding in these two cities with few benefits.

[2]No data is available on Patterson's affordable housing production.

POTENTIAL IMPACT OF A NEW INCLUSIONARY ZONING POLICY

To help policymakers understand the costs and benefits of a new inclusionary zoning (IZ) policy, models were developed for both the cities of Merced and Tracy. These models incorporated the current income distributions of households and the financial requirements for owning or renting housing in each area.

Two different IZ policies were considered:

- An IZ policy requiring builders and developers to set aside 5% of the units for any project to be allocated to lower income groups
- An IZ policy requiring builders and developers to set aside 15% of the units for any project to be allocated to lower income groups

The 5% IZ policy would target affordable for-sale and rental housing units toward two income groups according to the following formula:

- 60% Low Income: 50%-80% of average median income (AMI)
- 40% Very Low Income: 30%-50% of average median income (AMI)

The 15% IZ policy would allocate the production and distribution of affordable units based on the following formulas:

For-Sale Housing

- 60% Low Income: 50%-80% AMI
- 40% Very Low Income: 30%-50% AMI

Rental Housing

- 60% Very Low Income: 30%-50% AMI
- 40% Extremely Low Income: 0-30% AMI

The impacts discussed in this section involve calculations based on typical housing now being produced in the cities, costing tools, and inputs from builders and developers. Some builders suggested that a 15% IZ would boost unit costs by 15-20%. Many projects would require extensive design changes, while many builders and developers of conventional housing lack the experience and knowledge required for affordable housing. As a result, many builders and developers might choose to build in other areas, increasing the impacts shown in the analysis below.

THE CITY OF MERCED

Effects of a 5% IZ

The For-Sale Market

A 5% IZ would boost the cost of a typical new home in the city of Merced by 4.8% to $367,000. Total production would fall from about 650 units to 619 units. While 31 additional affordable housing units would be produced, 62 market-rate units would be lost. This means that for each new affordable unit produced, 2.0 fewer market-rate units would be made available to others seeking new housing. Affordability, measured in terms of the percentage of households who could afford a new home, would drop from 28% to 26%.

EXHIBIT 7

**5% IZ Policy Effects on For-Sale Housing
City of Merced**

City of Merced Total For-Sale	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	650	619	-31	-4.8
Affordable housing (AH)	0	31	31	NA
Market housing	650	588	-62	-9.5
Home price	$350,000	$366,748	$16,748	4.8
Change in MktH/AH, No. HH	NA	NA	-2.0	NA
Housing affordability share, %	28	26	NA	NA

SOURCE: CIRB, FBEI

The Rental Market

The results reveal that a 5% IZ inclusionary requirement for typical new projects developed for apartments or other housing intended to be rented would raise rents an average of 4.2% to about $1,459 per month across the City. Total rental-unit production would decline by 4.0%. For each new affordable unit produced, 1.8 market-rate housing units would be lost. Based on their incomes, the share of households who could afford a new apartment would drop from 37% to 36%.

EXHIBIT 8

5% IZ Policy Effects on Rental Housing
City of Merced

City of Merced Total Rental	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	75	72	-3	-4.0
Affordable housing (AH)	0	4	4	NA
Market housing	75	69	-6	-8.5
Monthly rent	$1,400	$1,459	$59	4.2
Change in MktH/AH, No. HH	NA	NA	-1.8	NA
Housing affordability share, %	37	36	NA	NA

SOURCE: CIRB, FBEI

The Total Market

Combining the for-sale and rental sides of the market, what would be the likely impact of a 5% inclusionary affordable housing regulation? Expected outcomes were calculated using an annual permit total of 725 based on recent trends of Merced.

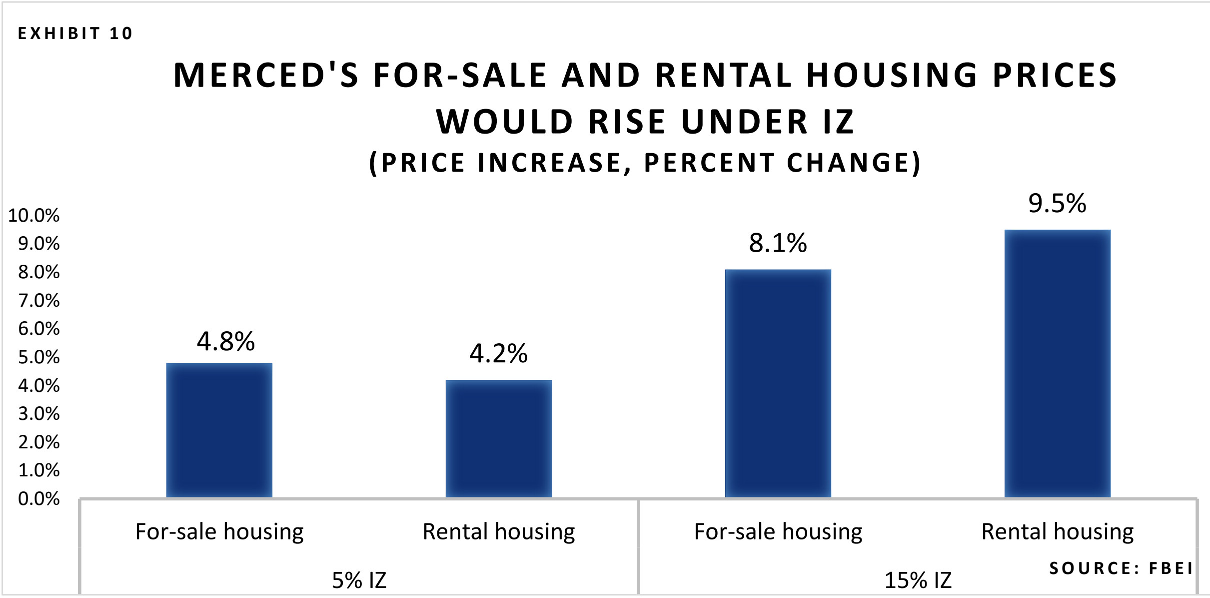
The citywide results show that the total number of housing units produced annually would fall from about 725 units under current market conditions to 691 units under a 5% IZ. This would be a drop of 4.7%. A total of just 35 for-sale and rental units would be added to the number of affordable housing units produced each year, while 68 fewer market-rate housing units would be produced. The trade-off from the proposed change in policy would be significant. For every new affordable housing unit produced for extremely low, very low, or low-income households seeking to own or rent, 2.0 other households would no longer be able to buy or even rent the home they had sought.

EXHIBIT 9

5% IZ Policy Effects on Total Housing
City of Merced

City of Merced Total	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	725	691	-34	-4.7
Affordable housing (AH)	0	35	35	NA
Market Housing	725	657	-68	-9.4
Change in MktH/AH, No. HH	NA	NA	-2.0	NA

SOURCE: CIRB, FBEI



Effects of a 15% IZ

The For-Sale Market

A 15% IZ would raise the cost of a typical new home in Merced by 8.1% to $378,000 from $350.000. Total production would fall from 650 units to 506 units, a 22% decline. While 76 affordable housing units would be produced, 220 fewer market-rate units would be made available. This means that 2.9 households seeking to buy a new home would be priced out of the market for each additional affordable housing unit that could be produced. Affordability, measured in terms of the percentage of households who could afford a new home, would decline from 28% to 25%.

EXHIBIT 11

15% IZ Policy Effects on For-Sale Housing
City of Merced

City of Merced Total For-Sale	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	650	506	-144	-22
Affordable housing (AH)	0	76	76	NA
Market housing	650	430	-220	-34
Home price	$350,000	$378,470	$28,470	8.1
Change in MktH/AH, No. HH	NA	NA	-2.9	NA
Housing affordability share, %	28	25	NA	NA

SOURCE: CIRB, FBEI

The Rental Market

The results indicate that a 15% IZ inclusionary requirement for typical new projects developed for apartment or other housing intended to be rented in the City would drive up rents an average of 9.5% from $1,400 to $1,533 per month. Total rental unit production would drop 17%. For every new affordable unit restricted to lower income households, 2.3 fewer new homes would be available to other potential buyers. Based on their incomes, the share of households who could afford a new apartment would drop from 37% to 34%.

EXHIBIT 12

15% IZ Policy Effects on Rental Housing
City of Merced

City of Merced Total Rental	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	75	62	-13	-17
Affordable housing (AH)	0	9	9	NA
Market housing	75	53	-22	-29
Monthly rent	$1,400	$1,533	$133	9.5
Change in MktH/AH, No. HH	NA	NA	-2.3	NA
Housing affordability share, %	37	34	NA	NA

SOURCE: CIRB, FBEI

The Total Market

Combining the for-sale and rental sides of the market, what would be the likely impact of a 15% IZ inclusionary affordable housing regulation on Merced?

The citywide results show that the total number of housing units produced annually would plunge 22% from 725 units under current market conditions to 568 units under a 15% IZ. A total of 85 for-sale and rental units would be added to the number of affordable housing units produced each year, while 242 fewer market-rate housing units would be produced. The trade-off from the proposed change in policy would be discouraging. For every affordable housing unit produced for extremely low, very low, or low-income households seeking to own or rent, 2.8 other households would no longer be able to buy or even rent the home they had sought.

EXHIBIT 13

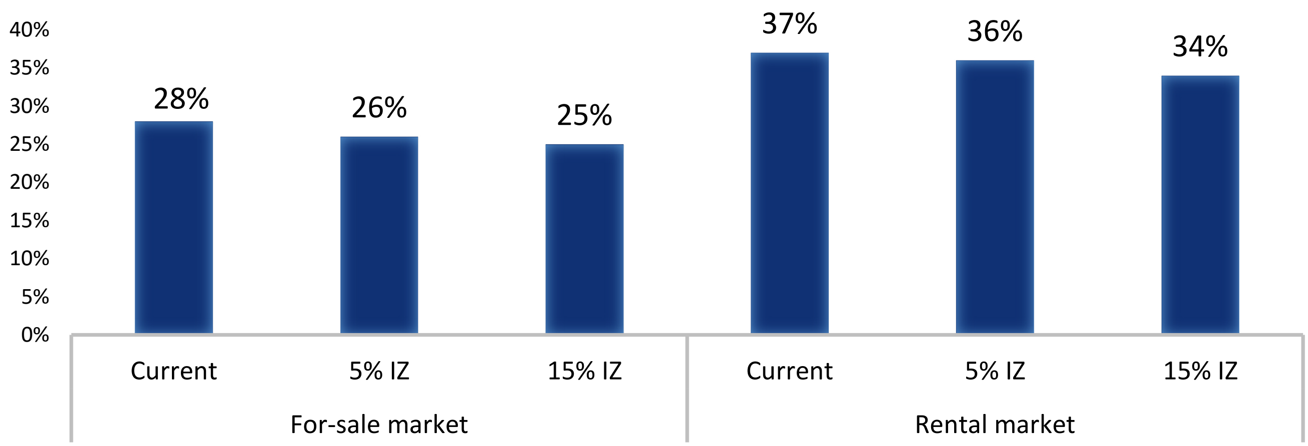
15% IZ Policy Effects on Total Housing
City of Merced

City of Merced Total	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	725	568	-157	-22
Affordable housing (AH)	0	85	85	NA
Market Housing	725	483	-242	-33
Change in MktH/AH, No. HH	NA	NA	-2.8	NA

SOURCE: CIRB, FBEI

EXHIBIT 14

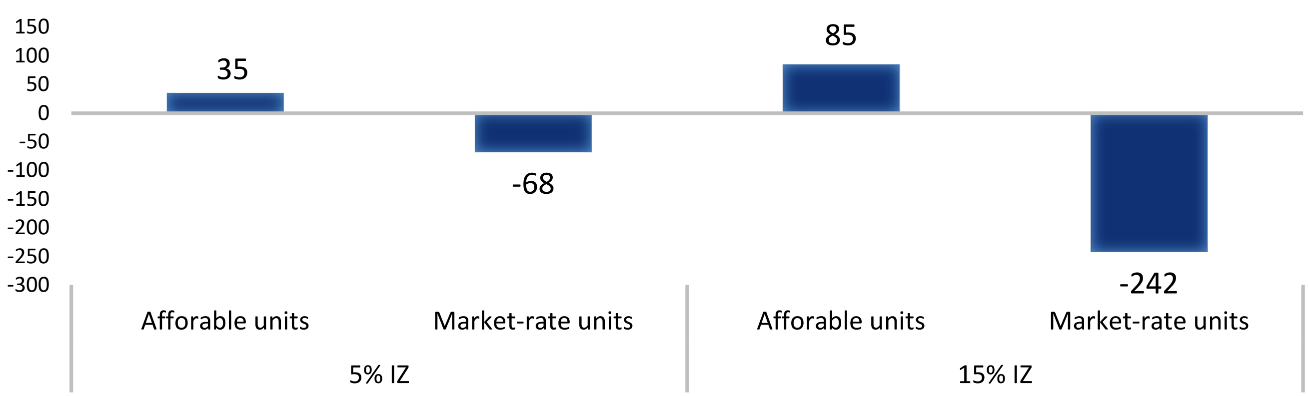
MERCED'S HOUSING AFFORDABILITY WOULD DROP IN ALL MARKETS
(AFFORDABILITY SHARE, PERCENT)



SOURCE: FBEI

EXHIBIT 15

IZ WOULD GENERATE MORE AFFORDABLE UNITS BUT LARGER LOSSES IN MERCED'S MARKET HOUSING
(CHANGE IN HOUSING UNITS, NUMBER)



SOURCE: FBEI

THE CITY OF TRACY

Effects of a 5% IZ

The For-Sale Market

A 5% IZ would boost the cost of a typical new home in Tracy by 4.2% to $729,000. Total production would fall from 600 units to 565 units, a decline of 5.8%. While 28 affordable homes would be built, 63 fewer market-rate units would be developed and produced. This means that 2.2 households seeking to buy a new home would be shut out of the market for each affordable housing unit that could be produced. Affordability, measured in terms of the percentage of households who could afford a new home, would drop from 24% to 22%.

EXHIBIT 16

5% IZ Policy Effects on For-Sale Housing
City of Tracy

City of Tracy Total For-Sale	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	600	565	-35	-5.8
Affordable housing (AH)	0	28	28	NA
Market housing	600	537	-63	-11
Home price	$700,000	$729,323	$29,323	4.2
Change in MktH/AH, No. HH	NA	NA	-2.2	NA
Housing affordability share, %	24	22	NA	NA

SOURCE: CIRB, FBEI

The Rental Market

The results reveal that a 5% IZ requirement for typical new projects developed for apartments or other housing intended to be rented would raise monthly rents 4.3% to an average of $3,338. Total rental production would fall from 335 to 313 units, a drop of 6.6%.

While 16 additional affordable housing units would be produced, 38 market-rate housing units would be lost. This means that 2.4 households would be priced out of the rental market for every additional affordable unit. Based on their incomes, the share of households who could afford a new apartment would drop from 28% to 26%.

EXHIBIT 17

5% IZ Policy Effects on Rental Housing
City of Tracy

City of Tracy Total Rental	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	335	313	-22	-6.6
Affordable housing (AH)	0	16	16	NA
Market housing	335	297	-38	-11
Monthly rent	$3,200	$3,338	$138	4.3
Change in MktH/AH, No. HH	NA	NA	-2.4	NA
Housing affordability share, %	28	26	NA	NA

SOURCE: CIRB, FBEI

The Total Market

Combining the for-sale and rental sides of the market, what would be the likely impact of a new IZ inclusionary affordable housing regulation on Tracy? Expected outcomes were calculated using an annual permit total of 935 units based on recent trends.

The citywide results show that the total number of housing units produced annually would fall from the 935 units to 878 units under a 5% IZ. This would be a drop of 6.1%. A total of just 44 for-sale and rental units would be added to the number of affordable housing units produced each year, while 101 fewer market-rate housing units would be produced. Increasing the number of affordable housing units would jeopardize the goal of advancing overall housing affordability. For each rental or for-sale home produced for a low-income household, 2.3 households would no longer be able to afford a rental or for-sale unit.

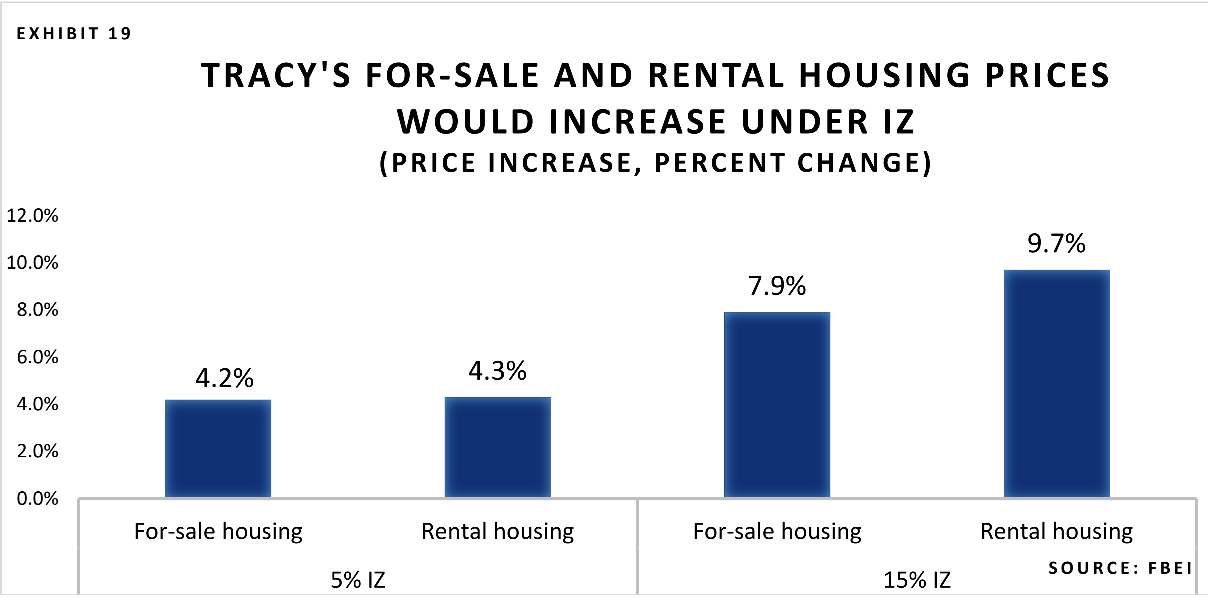
EXHIBIT 18

5% IZ Policy Effects on Total Housing
City of Tracy

City of Tracy Total	Current	5% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	935	878	-57	-6.1
Affordable housing (AH)	0	44	44	NA
Market Housing	935	834	-101	-11
Change in MktH/AH, No. HH	NA	NA	-2.3	NA

SOURCE: CIRB, FBEI

EXHIBIT 19



Effects of a 15% IZ

The For-Sale Market

A 15% IZ would boost the cost of a typical new home in Tracy by 7.9% to $755,000. Total production would fall 23% from 600 units to 465 units. While 70 new affordable homes would be built, 205 fewer market-rate units would be produced. This means that 3.0 households seeking to buy a new home would be shut out of the market for each affordable housing unit developed. Affordability, measured in terms of the percentage of households who could afford a new home, would drop from 24% to 20%.

EXHIBIT 20

15% IZ Policy Effects on For-Sale Housing
City of Tracy

City of Tracy Total For-Sale	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	600	465	-135	-23
Affordable housing (AH)	0	70	70	NA
Market housing	600	395	-205	-34
Home price	$700,000	$755,200	$55,200	7.9
Change in MktH/AH, No. HH	NA	NA	-3.0	NA
Housing affordability share, %	24	20	NA	NA

SOURCE: CIRB, FBEI

The Rental Market

The results reveal that a 15% IZ requirement for typical new projects developed for apartment or other housing intended to be rented would raise rents an average of 9.7% to about $3,510 per month across the City. Total rental production would fall from 335 to 260 units, a 23% decline.

While 39 additional affordable housing units would be produced, 114 market-rate housing units would be lost. This means that 2.9 households would be shut out of the rental market for every additional affordable unit that would be produced. Based on their incomes, the share of households who could afford a new apartment would fall from 28% to 24%.

EXHIBIT 21

15% IZ Policy Effects on Rental Housing City of Tracy

City of Tracy Total Rental	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	335	260	-75	23
Affordable housing (AH)	0	39	39	NA
Market housing	335	221	-114	-34
Monthly rent	$3,200	$3,510	$310	9.7
Change in MktH/AH, No. HH	NA	NA	-2.9	NA
Housing affordability share, %	28	24	NA	NA

SOURCE: CIRB, FBEI

The Total Market

Combining the for-sale and rental sides of the market, what would be the likely impact of a 15% IZ inclusionary affordable housing regulation on Tracy?

The citywide results show that the total number of housing units produced annually would plunge 22% from 935 units under current market conditions to 725 units under a 15% IZ. Although 109 new affordable units could be produced each year, this outcome would come at the expense of a lost 319 market-rate units. Increasing the number of affordable housing units would jeopardize the goal of advancing overall housing affordability. For each rental or for-sale home produced for a low-income household, 2.9 households would no longer be able to afford a rental or for-sale unit.

EXHIBIT 22

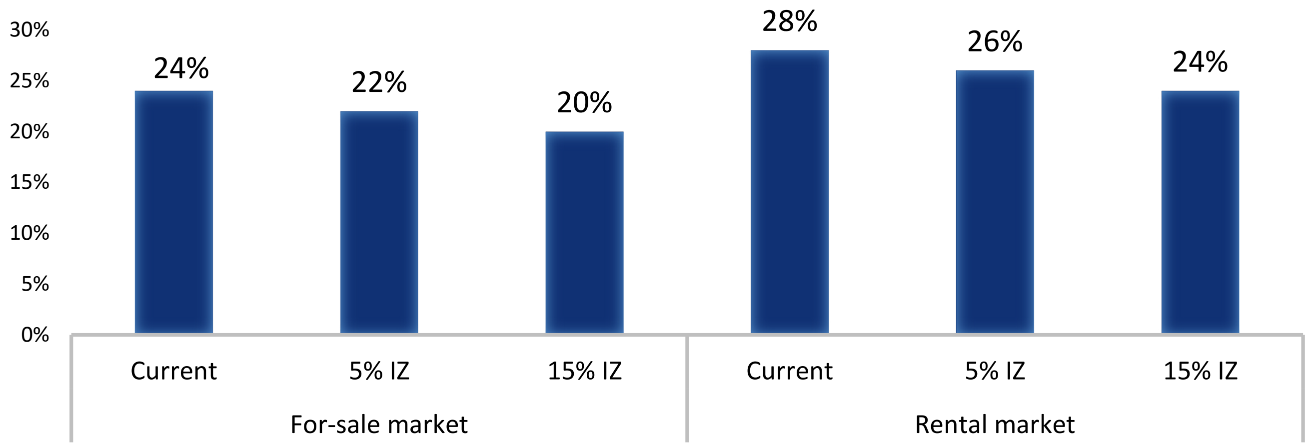
15% IZ Policy Effects on Total Housing City of Tracy

City of Tracy Total	Current	15% IZ	Change from current, Numerical	Change from current, Percent
Total housing permits	935	725	-210	-23
Affordable housing (AH)	0	109	109	NA
Market Housing	935	616	-319	-34
Change in MktH/AH, No. HH	NA	NA	-2.9	NA

SOURCE: CIRB, FBEI

EXHIBIT 23

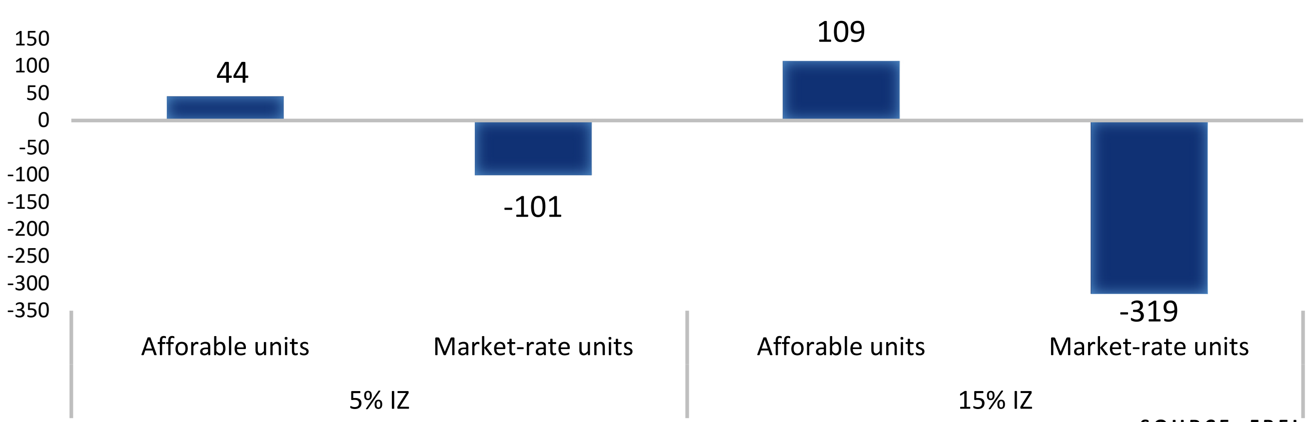
TRACY'S HOUSING AFFORDABILITY WOULD DECLINE IN ALL MARKETS
(AFFORDABILITY SHARE, PERCENT)



SOURCE: FBEI

EXHIBIT 24

IZ WOULD RAISE AFFORDABLE UNITS BUT CAUSE BIGGER LOSSES IN TRACY'S MARKET HOUSING
(CHANGE IN HOUSING UNITS, NUMBER)



SOURCE: FBEI

An In-lieu Option

Policymakers might structure their IZ policies allowing builders and developers to pay a fee rather than construct the units themselves. This would represent a less burdensome requirement and allow cities to leverage those fees with additional funding from government grants and bond issuance. Builders with particular expertise in affordable housing could be targeted for the deployment of these funds.

However, the ability of other California cities to generate significant volumes of affordable housing with this approach has been disappointing. More importantly, an in-lieu fee represents another tax on builders that would raise costs, reduce potential production, and push prices and rents higher.

Could Builders or Landowners Absorb the Additional Costs?

Assumptions that builders, developers, or landowners can absorb any cost increases due to policy changes, such as a new IZ requirement, do not square with reality. Builders and developers typically are working with the capital of other investors, rather than their own money, and therefore must deliver a specific rate of return. If investors cannot earn that rate of return in housing, they will divert it to other purposes.

Another argument often made is that land prices are a "residual" and will adjust lower should the "upstream" costs of building rise. Landowners, however, also have choices. They typically would accept at most a 5% drop in the price of their land, with many accepting no change. Instead, they would choose to continue with its current use, which typically involves a consistent earnings stream. Alternatively, they may direct their land to other uses or hold it off the market until conditions become more favorable in the future.

What Happens to Households Priced Out of the Market?

Households priced out of the new housing market with their current incomes may try to find lenders who will accept lower than a 20% down payment. The intense competition for new homes and stricter lending conditions may limit that option. Homebuyers may seek financial assistance from relatives, but the sustainability of that option may be limited if it involves more than the down payment. Potential new homebuyers could find less expensive options in the existing-home market but will encounter intense competition or bidding wars there and be ultimately forced back into the rental market.

How can individuals and families adapt to rents rising faster than incomes? Some will move into housing with other family members or friends. Others will move to less expensive areas, lengthening distances to work and jeopardizing the region's climate action goal to reduce greenhouse gas emissions. Some individuals will leave the region, hurting the ability of local companies to staff and grow their businesses. Some individuals may slide into homelessness.

POLICY PERSPECTIVES

As concerns have mounted over the affordable housing issue, three topics should be considered:

- » Why is the marketplace not producing the amount of affordable housing that many would like to see?
- » Who should be required to pay the cost for providing more affordable housing units?
- » What policy options could be considered to create more affordable housing?

Why the Market is Not Producing Enough Affordable Housing?

For many areas, the cost of land, labor and materials has pushed the expense of new home construction well above prices that lower income households can pay to rent or own a new property. Many regulations, the length of approval processes, and fees have also acted to drive up the price of housing, making it prohibitively expensive for lower income households as well as the middle class.

One estimate suggests that when time is included, total regulatory costs can account for as much as 40% of the cost of a new house in certain parts of California.[3] A recent study shows that fees alone for projects in the Central Valley typically average $55,000 per unit. Higher density projects generally face higher relative fee burdens than lower density developments, which discourages entry-level housing.[4]

Who Should Pay for More Affordable Housing

Three different constituencies might pay for more affordable housing.

- » Developers and Builders: This group, although typically charged with the responsibility of producing more affordable housing, is certainly not a costless channel. The production of more affordable units causes adverse effects on the overall housing market.
- » Employers: Affordable housing might be viewed as a company responsibility. Local employers might be taxed to generate more affordable housing. This could reduce their local hiring, drive them out of the region, and discourage the entry of new businesses.
- » Local Taxpayers: Affordable housing might be viewed as a public responsibility. Residents could be taxed through a special sales tax or increases in property taxes to pay for new affordable housing bonds.

Each of these options will have significant side effects and will impose costs on each group.

Policy Tools to Consider

Policymakers hoping to increase the amount of affordable housing have three primary choices:

1. Remove some of the barriers currently preventing such housing
2. Mandate that affordable housing be supplied
3. Provide incentives to spur the construction of more housing

[3] "Opening San Diego's Door to Lower Housing Costs." Fermanian Business & Economic Institute at PLNU, 2015.

[4] "Residential Development Impact Fee Comparison Study." Economic & Planning Systems, Inc., May 2021.

Remove Barriers

While many of the regulations and fees put into place over the past two-to-three decades may have seemed justified at the time they were implemented, their cumulative impact has driven home prices up and production down. The cost of time involved in project approval timelines and various lawsuits has also been oppressive. Fee reductions and streamlined permitting could spur the creation of more affordable and workforce housing.

Mandate Affordable Housing

Mandating that affordable housing be produced, as demonstrated in this report, is not a productive solution, but rather can result in negative effects. Charging in lieu fees to generate funding for affordable housing, while a less costly alternative, still represents a tax on homebuilding. It will result in less housing at higher prices.

Provide Incentives

The final approach involves incentives for building more affordable housing. The cities of Seattle, Salt Lake, and San Francisco have recently scored some successes with affordable housing policies that embraced the following:

- Bond funding
- Grants
- Tax exemptions
- Tax credits
- Low-interest loans
- Allowances for higher densities

Solving the Affordable Housing problem deserves careful attention to all of the issues above: The source of the problem; who should bear the responsibility for its solution; and the basic approach to be used.

CONCLUSIONS AND RECOMMENDATIONS

The Central Valley's experience with inclusionary zoning policies and the simulation results presented in this report should give Merced and Tracy policymakers reasons for pause in following the IZ path. Such a policy would be counterproductive by reducing the total supply of new housing when more housing is needed, not less.

Higher new home prices and rents would reduce affordability, further harming many of the region's households. For every lower income household who might gain access to an affordable unit, 2-3 households would be shut out of the market.

While some builders might possess the ability to allocate 5% or 15% of their units to affordable units, many lack the expertise in affordable housing. Developers of small or even medium-size projects could find it prohibitively expensive to allocate 5% or 15% of their properties to affordable units. Lacking the ability to benefit from economies of scale, these projects would be unfeasible. This would be especially true where a significant gap exists between market rates and the required pricing for affordable units.

Other builders and developers would find it impractical to combine a lower income component as part of their projects without massive design changes. Many could choose to develop and build their projects in other areas without the constraints of IZ regulations. This trend could exacerbate commute times and counter environmental efforts to reduce greenhouse gas emissions.

Policymakers hoping to increase the amount of affordable housing should first look to lowering some of the barriers blocking more homebuilding at lower prices. Reduced fees, accelerated permit processing, and the allowance of higher densities would be helpful. A dedicated funding stream, financed through government and private capital, could be focused on affordable housing. It could fund various incentives, such as tax credits, grants, or low-interest loans. It could also be targeted directly to builders and developers who have a comparative advantage with affordable housing projects.

These would be much more productive solutions than an IZ policy that imposes more costs than benefits.

APPENDIX A - METHODOLOGY

MODELING OF INCLUSIONARY ZONING POLICIES

Builders and developers in the cities of Merced and Tracy were consulted regarding the types of projects that are currently being built in those cities. Base costs, home prices, and rents were established for both the for-sale and rental markets.

Costs of a 5% inclusionary zoning (IZ) policy were then estimated. Such estimates were developed under the assumption that a new IZ policy would require that each housing project contain 5% of its units dedicated for two income groups:

- 3% Low Income: 50%-80% of average median income (AMI)
- 2% Very Low Income: 30%-50% of average median income (AMI)

Costs of a 15% inclusionary zoning (IZ) policy were also estimated. Such estimates were developed under the assumption that a new IZ policy would require that each housing project contain 15% of its units dedicated for the following income groups:

For-Sale Housing
- 9% Low Income: 50%-80% AMI
- 6% Very Low Income: 30%-50% AMI

Rental Housing
- 9% Low Income: 30%-50% AMI
- 6% Very Low Income: 0%-30% AMI

Housing affordability models were developed for both the for-sale and rental segments for the cities of Merced and Tracy. Affordability in each area was based on the distribution of household incomes as provided by the nationally recognized demographics research firm, Claritas. Where 2021 statistics were not available, FBEI estimated income distributions based on U.S. Bureau of the Census statistics.

This evaluation allowed the calculation of affordability, as measured in terms of the share of households that could afford the different types of projects under current conditions versus ones with either a 5% or 15% IZ. It also allowed estimates to be made of the maximum amount of construction that could take place in each area under the various cases.

Housing permit trends of recent years through 2020 were used to determine the base totals for the for-sale, rental, and total production levels for Merced and Tracy. Production reductions under the 5% and 15% IZ policy alternatives were estimated based on the percentage changes in the number of households qualifying for purchase or rent at the higher price points. Calculations were checked for reasonableness and consistency with other studies and research conducted by FBEI.

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