COUNCIL AGENDA 11/10/08
ITEM 1

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Councilmember Sam Liccardo

SUBJECT: **INCLUSIONARY ZONING PROCESS AND POLICY**

DATE: November 10, 2008

APPROVED: 11-10-08

BACKGROUND

Inclusionary Zoning Process and Policy

Since the issuance of the October 24, 2008 memorandum from Councilmembers Constant and Oliverio, various fervent and occasionally factual assertions have circulated regarding the process conducted by the Housing Department, as well as about the merits and limitations of inclusionary housing (IZ) policies.

There's more to come. IZ opponents will soon release a developer-funded poll that will predictably demonstrate that if respondents are asked a series of highly leading or misleading questions, they'll reply with an expression of disdain for whatever the questioner has defined to be "inclusionary housing."[1]

With this memorandum, I seek to clarify concerns about the process, and with Attachment A, I seek to respond to several "myths" about inclusionary housing that have gained currency among IZ's opponents.

An Extensive, Public, Eighteen-Month-Long Process

Contrary to the suggestion of the Constant/ Oliverio memo, nothing about this process has been rushed. This process began a year and a half ago, when the Council unanimously approved its Five-Year Housing Investment Plan at a June 19, 2007 hearing. The memo included an explicit recommendation to soon "consider expansion of the City of San Jose's inclusionary policy…perhaps adopting a citywide inclusionary policy." (p. 3) Two months later, on August 15, 2007, Councilmembers Campos, Chirco, Nguyen, and Liccardo co-authored a memo to urge study of a citywide inclusionary policy. Since that time, through the efforts of the Housing Department, we've seen:

- Over 30 one-on-one meetings with developers and community stakeholders

[1] Naturally, the proponents of any such poll should release the entire text of all of the questions asked of respondents, so that any response can be scrutinized in its proper context. Our collective experience with "creative" polling should invite skepticism of any results funded by advocates on one side of an issue or the other.

- 17 council committee or commission meetings, all open to the public
- 6 public "stakeholder" meetings to discuss economic modeling and cost estimates
- 8 public outreach meetings in various city libraries and City Hall
- Numerous newspaper articles and editorials

Notably, Councilmember Constant complained at the June 17th meeting that the residents of his district had not had ample time to provide meaningful input. Since that time, five public outreach meetings have been held, including one at the West Valley Branch Library in his district. At a recent Rules Committee hearing, Councilmember Constant complained of his lack of notice of those meetings, yet the Housing Department has issued several meeting notices by email and memoranda, distributed to *every* council office dating back to January 10th, as well as to an email list of 700 recipients in the community. Additional outreach will be forthcoming, as indicated in Leslye Krutko's November 6th memorandum. No city policy, with the exception of the General Plan revision, has received such extensive public scrutiny as IZ.

Focus Driven by Council Direction, Not Housing Staff

Councilmembers Oliverio and Constant also accuse Housing staff of having imposed blinders on the Council, unilaterally narrowing our focus to IZ to the exclusion of other policy options. This assertion ignores the two occasions on which Council clearly directed staff to focus on IZ. On December 11, 2007, Council approved a public process for moving forward, and explicitly conditioned its vote to "limit the scope of study to how an inclusionary zoning ordinance would work in San Jose." On June 17, 2008, Council voted to direct staff to "return in Fall 2008 with an inclusionary housing proposal for Council approval that contains a range of alternatives, but which. . . at a minimum . . .expands inclusionary obligations beyond redevelopment areas." Each of these votes was taken with knowledge that other programs and options could continue to be explored through other processes, as outlined in the Five Year Housing Investment Plan, but that those other policy options would not be used as a red herring to distract the Council.

In short, there is no conspiracy by the Housing Department to impose inclusionary zoning upon an unwilling or inattentive Council. Council has approved each of these steps deliberately in public hearings, and this process has run its appropriate course.

Now is the time to move forward.

APPENDIX A to Councilmember Liccardo's Memorandum:

Ten Myths of Inclusionary Zoning

Myth #1: ***IZ programs don't create very many affordable units.***

The best gauge for assessing IZ's effectiveness comes from San Jose's own experience with the policy in its redevelopment project areas, covering 18% of the city's land area. According to the City's Five-Year Plan (p. 58), the City's policies resulted in the construction of 1,898 affordable homes in redevelopment areas in the three years between 2003 and 2006.[1] Even opponents of IZ's citywide expansion concede its success: San Jose-Silicon Valley Chamber of Commerce CEO Pat Dando admitted in the March 2008 Chamber *Advocate* that "The city of San Jose has been very successful at creating affordable housing in its redevelopment zones by requiring inclusionary housing throughout neighborhoods."

This begs the question: if this policy is "successful" in some of the city's neighborhoods, why should it be a "failure" in the others?

Myth #2: ***Voluntary programs work better, like the incentives-based policy in Austin, Texas.***

In their October 24, 2008 memorandum, Councilmembers Constant and Oliverio hold Austin, Texas, as a shining example of some better alternative, where "voluntary incentives" build affordable housing at a faster clip than IZ policies will. Nobody doubts that incentives for affordable housing can be effective, and that satisfying our affordable housing needs will require many tools beyond IZ.

That hardly means that voluntary programs suffice as a substitute for IZ. In the case of Austin, my colleagues overlook several glaring facts. First, affordable housing comes far more cheaply in Austin, where the $183,700 median home price in 2007, a small fraction of the median price in San Jose. Since tech-heavy Austin still boasts $65,000 salaries for starting engineers, affordability comes far more easily in Austin.[2] For that reason, "thousands" of "affordable" units trumpeted under Austin's fast-track "SMART Housing" plan actually amounted to nothing more than market-rate units. Thousands more had merely one-year affordability restrictions, allowing the buyer of an "affordable" unit to resell it the following year at market rate, reaping a huge windfall but diminishing the city's aggregate stock of affordable housing. Making housing "affordable" by Austin's standards does not require much effort.

Most importantly, when Austin's leaders encountered an opportunity to redevelop its former airport site with tens of thousands of units of housing, ***the City of Austin imposed a 25% affordability requirement*** in the development agreement with the builder, Mueller. Austin's civic leadership understood well that if it wanted affordable housing, it could best do so with an

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[1] Other Bay Area cities with IZ programs can similarly boast; Petaluma and Dublin each report having built over 1,000 units with IZ programs. Outside of California lie ample examples of success; for instance, Montgomery County, Maryland, has produced some 12,000 affordable homes with its IZ policy.

[2] See *http://www.austinchamber.org/DoBusiness/GreaterAustinProfile/costs.html*.

inclusionary requirement—***at a percentage exceeding the 20% cap approved by San Jose's City Council*** in June. Austin hardly serves as an exemplar of "voluntary-only" housing programs, despite the fact that its housing stock remains vastly cheaper than San Jose's.

Myth #3: *"Inclusionary housing policies drive up the cost of market-rate housing for the rest of us."*

This assertion, often repeated by IZ opponents, has little basis in fact or theory. Even the Home Builders Association's most recent "Position Paper" relies on a 2007 study that found **"no evidence that IZ programs have had an [adverse] impact on either the prices or production rates of market-rate houses in the San Francisco Bay Area,"** where 55 cities and counties currently have IZ programs. That study, by economists at New York University's Furman Center and the Center for Housing Policy, constitutes the most comprehensive analysis of the impact of hundreds of IZ programs nationwide.[3] (Although very small price increases appeared to result in the Boston area, the study points to the inferior and overly rigid design of those IZ policies—see the discussion concerning Myth # 9, below.)

Opponents rely on a simplistic notion of housing markets, assuming that homebuilders simply pass on additional costs that they incur to buyers, who must in turn pay the additional cost in the form of a higher price.

In fact, markets are more complex. The effect of higher costs on the prices of houses, food, or any other commodity, depends mightily on what economists call the *price elasticity* of consumer demand. That is, if homebuyers will continue to buy homes regardless of price escalation—that is, their demand is relatively *inelastic* to price--then developers can readily "pass through" these costs to the buyers. Consumers with inelastic demand include, for instance, an alcoholic at a liquor store, or the driver of a gas-guzzling Mercedes at the pump. On the other hand, if potential buyers' decisions are highly price-sensitive—as we expect from common experience--then developers will not increase prices significantly, because they won't be able to sell homes at higher prices.

In fact, we know that developers don't simply pass on cost increases to buyers, because they know that home buyers are highly price-conscious.[4] Consider San Jose's recent experience with rising building materials costs: building booms in Asia drove the costs of steel, copper, lumber, and drywall up 30% or more annually in 2006 and 2007. Yet between April 2006 and January 2007—a period of significant economic growth in the Valley *before* the current recession--single family home prices *declined* 11% in San Jose, according to the Santa Clara County Association of Realtors.[5]

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[3] "The Effects of Inclusionary Zoning on Local Housing Markets: Lessons from the San Francisco, Washington, D.C., and Suburban Boston Areas," March 2008.

[4] IZ opponents often rely on a 2002 article by economists Edward Glaeser and Jospeh Gyourko ("Zoning's Steep Price," Regulation, Fall 2002) to suggest the pitfalls of land use regulation, yet its findings only further serve to undermine this simplistic connection between development costs and home prices. Glaeser and Gyourko reported that several large and medium-sized U.S. cities had a large percentage of homes whose 1999 prices actually sank well *below* the cost to construct the same house at that time.

[5] Monthly construction costs increased 1 to 2 % *per month* throughout this time, according to the San Jose Business Journal (July 18, 2008, p. 18).

If developers don't pass on the costs to home buyers or renters, who pays for the cost of IZ? Some portion may come out of a developer profit, but the research suggests that in the long run, developers ultimately will pay less for land from property owners.[6]

What's the lesson here? Higher development costs do *not* necessarily translate to higher prices for San Jose home buyers. Developers know that they can't simply pass along the costs of IZ to home buyers any more than they can pass along the rising cost of wood or steel. Most prospective home buyers have elastic--or price-sensitive—demand. For that reason, IZ policies are not likely to drive up market-rate prices.

Myth #4: ***"An inclusionary housing policy will scare away new development from San Jose, and will constrict our housing supply."***

News flash: an inclusionary policy *already exists* in San Jose. It governs most of the redevelopment project areas. Our experience in those areas—where the city requires builders to either make 20% of their units affordable or pay a fee—appears instructive, as they contain thousands of recently-constructed affordable and market-rate homes. In fact, although redevelopment project areas with inclusionary requirements make up only 18% of the city's land, they contain 43% of the housing produced in San Jose over the past five years, and an estimated 56% over the next five.

Two examples are telling. In North San Jose, policy changes in 2005 allowed developers to apply for entitlements to build 32,000 homes for the first time, but only if they swallowed the cost of $500 million in transportation improvements, *in addition to* the pre-existing 20% inclusionary housing obligation. Yet when the Planning Department opened the door to applications in 2006 for the first phase of 8,000 residential units, the turnstiles spun so quickly that applications have already "maxed out." Developers have entitled more housing in North San Jose than in any other *entire city* in the Bay Area over the same span of time—again, *in spite of* a 20% inclusionary obligation.

In Edenvale—another area subject to a 20% inclusionary requirement—developers Lew Wolf and Ed Storm continue to engage in negotiations with city officials to build a $100 million stadium if the city will convert 74 acres of land to residential use. Again, the 20% affordable requirements haven't deterred those developers from building housing in that area—they're *actually willing to pay $100 million just for the right to do so!*

The study by the NYU's Furman Center confirms San Jose's experience, concluding that the impact of IZ policies in 47 jurisdictions in the Bay Area showed no constriction of housing supply historically.

[6] Support can be found from the various studies cited at page 11 of Victoria Basolo and Nico Calavita, "Policy Claims with Weak Evidence: a Critique of the Reason Foundation Study on Inclusionary Housing Policy in the San Francisco Bay Area," June 2004

MYTH #5: *"Don't several objective academic studies show that IZ will drive up prices and reduce market supply?"*

A few papers compiled by the same small group of economists[7] have been trumpeted by IZ opponents in the development industry as "proof" of the evils of inclusionary housing, and that IZ will constrain housing supply and inflate prices.

Before looking at these studies' oft-discussed flaws, it's helpful to consider the source. The studies emanate from two related libertarian organizations, the Reason Foundation and the Independent Institute.

The Reason Foundation fueled its research with funds from several industry lobbying groups, such as the California Association of Realtors. This funding link gains meaning when viewed in context: the same Reason Foundation put its name behind oil company-funded studies suggesting that hybrid cars don't save gas, and pushed a Phillip Morris-funded study attacking the EPA's warnings of the harms of second-hand smoke. After accepting funding from American Petroleum Institute, Chevron, and Shell, the Independent Institute and Reason Foundation produced various studies arguing that hybrid cars consumed more energy than the standard gas-guzzlers, urging for more off-shore drilling, and questioning the need for urgent action to curb greenhouse gas emissions. These are far from objective institutions. In the context of housing, the Reason Foundation's ideas for increasing affordable housing consist largely of the elimination of growth controls such as greenlines, hillside development restrictions, and low-density zoning.

Those studies suffer from widely-criticized methodological flaws, often due to overly simplistic assumptions that even a casual observer can note. For example, the Powell and Stringham's 2004 study depends on several farfetched assumptions: that IZ applies only to owner-occupied housing (IZ is most effective in producing rental housing), that California cities don't allow developers to pay fees in lieu of building units (most do), and that California cities don't offer incentives or cost off-sets for affordable housing development (nearly all do).[8] Most importantly, it fails to compare the experience of cities with IZ against those cities without the policy. This omission overlooks the fact that in *all* cities, easily developable land becomes increasingly scarce over time. As a result, every California jurisdiction has faced steep increases in home prices over the study period, whether the jurisdiction had an IZ policy or not.

One anti-IZ study, by Tom Means, Edward Stringham and Edward Lopez, did attempt to compare IZ and non-IZ jurisdictions with the use of regression analysis, but did so with such a simplistic model that it assumed that all cities had uniform market conditions prior to the enactment of the policy.[9] Obviously, the housing markets and development capacity of

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[7] *See, e.g.,* Tom Means, Edward Stringham, and Edward Lopez, "Below Market Housing Mandates as Takings: Measuring their Impact," The Independent Institute, November 2007; Benjamin Powell and Edward Stringham, "Housing Supply and Affordability: Do Affordable Housing Mandates Work?" The Reason Foundation, April 2004.
[8] *See, e.g.,* Victoria Basolo and Nico Calavita, "Policy Claims with Weak Evidence: a Critique of the Reason Foundation Study on Inclusionary Housing Policy in the San Francisco Bay Area," June 2004.
[9] In technical terms, the Means & Stringham study used a "first difference estimation," which relies on data from only two points in time: when the policy was enacted, and a second point years later. The standard econometric approach in this context (i.e., a "treatment" study) would utilize "difference-in-difference estimation," which would

California cities vary widely. It seems logical to assume that cities that enacted IZ policies did so because their elected leaders faced greater pressure to respond to high housing costs, so housing markets in those cities would *already* have been more prone to price escalation and production constraints before they enacted IZ. The Means & Stringham study ignores this fact, resulting in highly biased results.

Myth #6: *"This proposal will hit homebuilders at a time when they can least bear the impact."*

The proposal that the Council approved on June 17th specifically exempts any project that has already entered a multi-year-long "pipeline" from the imposition of any inclusionary obligation. That is, a developer who may be years away from breaking ground, but who has submitted a completed application to the planning department, can be "grandfathered" and avoid any inclusionary requirement. In short, the June proposal won't affect the overwhelming majority of the homes likely to be built in the next two to three years. It will have an impact on future developments as the economy recovers in 2010 and beyond, giving developers ample time to set their investment expectations and financing accordingly.

If anything, the current stall in any new development presents the Council with an opportune time to consider modifications to San Jose housing policies, since it can do so without drawing arbitrary lines among a flood of development proposals that would otherwise race through the Planning Department's door.

Myth #7: *"San Jose's affordable housing problem will be resolved by the ongoing decline in median home prices."*

Home price variations don't have much impact for most of our younger workers and families strained by housing costs, because they lack the financial means to access anything other than rental housing. When discussing the availability of affordable housing in San Jose, then, the playing field consists largely of the rental market. In this downturn, the need for affordable rental housing has grown only more acute. Amid the national real estate collapse, average rents in the San Jose metro area in the third quarter of 2008 continued to rise, up 5.2 % over their levels the prior year. At an average rent of $1,709 per month, metro **San Jose continues to have the most expensive rents among the 25 metropolitan areas in California,** and occupancy levels remain at 95.6%.[10] In short, rental housing continues to be expensive, and ownership continues to elude most working-class residents in this city.

What about those buyers who now face a more affordable market in owner-occupied housing—are their problems resolved? Hardly. The California Association of Realtors reported in mid- 2008 that only 31% of Santa Clara County's first-time homebuyers could afford a home.

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require researchers to gather data from a date *prior to* the time when the policy was enacted. Doing so would help capture the wide variations in cities' housing market conditions prior to the enactment of the policy. The study also suffers from unjustified assumptions about functional form; the researchers estimate a model using log housing prices with no empirical justification other than stating that it provides "convenience" in interpreting results.

[10] *San Jose Mercury News,* October 15, 2008, p. 12.

While 31% marks a slight improvement over 2007, it remains significantly lower than any year prior to 2006. Simply, the key measures of affordability don't improve much where incomes and jobs decline along with sale prices.

Myth #8: ***"Inclusionary housing will cause neighborhoods to deteriorate with 'public housing' projects."***

Affordable housing does not depress neighborhood home values. After the National Association of Realtors reviewed the available data, it concluded that "[m]ost studies indicate that affordable housing has no long-term negative impact on surrounding home values. In fact, some research indicates the opposite." [11]

Understanding what affordable housing development actually looks like in San Jose becomes critical to understanding the impacts of its integration into our neighborhoods. Extraordinary developments with award-winning design already accentuate San Jose's neighborhoods, and appear indistinguishable from market-rate housing. Far from deteriorating, neighborhoods with inclusionary housing requirements have seen property values appreciate in step with the best neighborhoods in San Jose. Our own Redevelopment Agency noted a 100% increase in property valuation in the "Strong Neighborhood Initiative" areas—the very neighborhoods with an inclusionary mandate--in the six years studied between 2001 and 2007. Affordable housing, when properly constructed and designed, can enhance a neighborhood substantially.

Myth # 9, ***"All Inclusionary Zoning Policies Are Alike, so If We Find One Bad Example of IZ, Then We Know It Won't Work in San Jose".***

Inclusionary policies differ *enormously*. The 2007 Furman Center's study of inclusionary programs in 105 U.S. cities concluded that while "the debate has tended to treat IZ as a single monolithic policy, ...many of the policies that local governments adopt and refer to as IZ look quite different from one another. . . . IZ is an extremely nuanced and flexible mechanism for providing affordable housing." In that study, cities in the San Francisco Bay Area imposed mandatory inclusionary programs without adversely affecting housing supply or market prices, while the 99 jurisdictions with the Boston area imposed varying forms of IZ policies that resulted in "small decreases in production and slight increases in the prices of [market-rate] single family houses."

Why different findings between the Bay Area and Boston? The Bay Area cities designed better policies, even though they were more likely to be mandatory and required deeper price discounts. In the Bay Area, cities tended to offer developers more flexibility in how they constructed the units, and they added incentives for building the units. For example, in the Bay Area, most of the cities allowed developers to pay fees in lieu of building the units; not so in the Boston metro area. San Jose, it should be noted, also allows developers to pay "fees in lieu."

[11] www.realtor.org/library/library/fg504

These findings reflect a critical fact: *not all inclusionary policies are alike.* Critics of IZ programs frequently overlook this fact, and point to anecdotal evidence of poorly-implemented programs in one or two jurisdictions. Yet the design of the programs varies widely in crucial ways—some are mandatory, others are voluntary. Some jurisdictions mandate affordability of 20% or more of the units, others as little as 5%. Some cities require developers to build all of the affordable units on the same site as the market-rate units, others don't, and still others --including San Jose--allow developers to pay a fee in lieu of developing the units. Dozens of other policy details have major impacts on an IZ program's efficacy.

MYTH #10: ***Inclusionary Housing will adversely impact the City's Budget.***

In recent weeks, some opponents have arrived at unfounded conclusions about the purportedly adverse financial impacts of IZ on the city budget. No such impact will result. If a private developer builds affordable rental or owner-occupied units within a project, the owner pays the same property tax as she would pay on any other residence. Even if a home is sold below-market, the County Assessor will impose property tax *as if it sold at the market rate*, so the city and county won't lose revenue with IZ. Nonprofit developers of stand-alone affordable housing will not pay property taxes, but they don't pay property tax now, either. In short, nothing changes.

If, as opponents vociferously argue, IZ polices will curtail housing development and drive up housing prices, then one should expect the city's budget picture to *improve*. Why? First, higher housing prices mean higher property assessments. Second, residential dwellings consume more in services than they provide to the city in taxes (while industrial or commercial taxpayers, conversely, provide more than they consume), so *reducing* the growth in housing in San Jose will only improve the city's fiscal situation. Of course, the evidence does not support the notion that well-designed IZ policies will constrict supply, so in either case, no reason exists to fear any fiscal impact.

At most, one can point to the existing exemption of affordable developments from PDO/PIO fees, the fees used to build new parks or make capital improvements to recreational amenities. The Council and City staff has publicly discussed the need to re-evaluate how PDO fees are imposed and how parks are financed, to ensure that communities with affordable housing are not short-changed in park development. That public process will follow this one, but Council cannot, and should not, seek to do all things at once.