

ESTIMATING THE EFFECTS OF PRICE CONTROLS IN THE REDEVELOPMENT OF THE FORT ORD MILITARY BASE

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Executive Summary

This study examines the impact of affordable housing quotas on the Fort Ord Redevelopment. We examine how these quotas will impact the housing supply, home prices, low-income families, and local government finance. We also explore alternative methods to improve home affordability. Some of the main findings are:

- An affordability mandate is essentially a price control that prevents builders and subsequent owners from selling or leasing at market prices.
- **Increasing the affordability quotas in Fort Ord from 20 percent to 50 percent would decrease the value of the land by almost \$300 million.** That would be lost money that the Fort Ord redevelopment will not be able to provide for the cost of infrastructure, deconstruction, cleanup, and other programs.
- Imposing the 50 percent quota would drive down builder revenue so much that **government would need to pay developers approximately \$50 million** and give them the land for free just to entice anyone to build.
- Any increase in the affordability quotas would cost local governments future tax revenue. The 50 percent affordability requirement would result in a **decline in tax revenue for local governments of at least \$5 million per year.**
- The decrease in assessed valuation would **reduce the available tax increment by \$30 million to \$40 million.**
- Governments would be required to tax the rest of the community more heavily or cut back services.
- Affordability price controls create a shortage where quantity of housing demanded exceeds the quantity supplied. A 50 percent affordability quota would create an even worse shortage than what exists today.
- Price controls would lead to a lower quantity of homes being built and displace families who could have bought at market prices. This drives up the cost of housing for all families who are not fortunate enough to get the few price controlled homes.
- Building below-market homes displaces families who wanted to pay the market price and prevents everyone from improving their living situation
- When high-priced new construction is built, all income levels benefit. High-income families can move into the new homes, moderate-income families move

into the homes that the high-income families move out of, and low-income families move into the homes vacated by the moderate-income families.

- Building below-market housing will enable fewer families to move and fewer families to improve upgrade. The overall stock of housing will be decreased by more than \$500 million.
- The affordability quota would create a two-tiered housing market: one market with price controlled units, and the other with more expensive housing that now can be afforded only at higher incomes.
- Price controlled units can continue to subsidize households for years, ignoring the fact that their incomes may increase.
- Housing is a long-term commitment, but evidence shows that income varies throughout the course of a lifetime.
- The incentives created by the price controls lead families to live in their homes longer than optimal, which will further prevent families in need from being able to move into the units.
- Price controls prevent appreciation, so they do not give low-income families all of the normal benefits of homeownership.
- Since owners of restricted units will never be able to sell at market price, the incentives to maintain property are taken away, making it more likely that price-controlled units will deteriorate over time.
- Inclusionary zoning regulations decrease asset value and are so economically inefficient that they are one of the worst means of providing affordable housing.
- Inclusionary zoning is the equivalent to a tax on housing whether the government requires builders to actually build the units or requires payment of an in-lieu fee.
- A special tax in the housing industry will lead to buyers paying more, sellers earning less, and fewer houses being built.
- Any increase in the affordability regulations is a step in the wrong direction. Fort Ord Reuse Authority should set the affordability restrictions as low as possible, ideally at zero.
- The best solution is to remove impediments to builders and speed up the process to allow supply to meet demand.

1. Introduction

The purpose of this study is to assess the economic impact of affordable housing regulations. We examine the general impacts of the regulations on the supply of homes, home prices, effects on lower-income families, and local government finance. This study specifically looks at the effects of Congress Member Sam Farr’s proposed policy change under consideration by Fort Ord Reuse Authority (F.O.R.A.), which would call for an increase in the number of price-controlled units from 20 percent to 50 percent (See Table 1). Affordability is defined by how much a family in each income category could afford if 30% of income is spent on housing. The homes with price restrictions would have an average price of \$193,000.¹

High housing costs in Northern California, especially for those earning less than median income, concern us all. When prices rise faster than income, residents have to pay a high percentage of their income on housing, and it causes them to live in smaller quarters than they desire. The question is not whether we want to make housing more affordable. We all do. The real question is whether Congress Member Farr’s proposal to raise affordable housing quotas in Fort Ord will achieve this goal. Straightforward economic analysis says that it will not.

Economics enables us to analyze how people will respond to the change in incentives from increasing affordable housing quotas. If one ignores economics, it is easy

Income Classification	% of Median Income	Estimated Home Price	Existing County Requirement	Proposed Quota Requirement
Very Low	50% or Less	\$88,440	6%	10%
Low	50%-80%	\$123,817	6%	10%
Moderate	80% - 120%	\$227,000	8%	20%
Work Force	120% - 150%	\$301,000	0%	10%
Total Number of Units with Price Controls			20%	50%

to arrive at misguided policy prescriptions. Despite the good intentions of those who want to mandate affordable housing, economics tells us that affordable housing quotas will have the unintended consequence of reducing the quantity of housing available and

¹ The effects are similar whether builders sell the housing to families at below-market rates or to a management company that will lease at below-market rates. When tenants rent at below-market rates, the present discounted value of future earning streams from the property is lowered to an equivalent of the affordable sales prices in Table 1. We discuss the 9 percent tax credit for building affordable rental housing below.

failing to reduce prices. If we want to decrease housing prices, we must pass policies that will increase the quantity of housing available, and oppose those that would restrict supply such as the proposed affordable housing quota in Fort Ord.

2. Estimating the Costs of Affordable Housing Mandates in Fort Ord

The first issue to realize is that an affordable mandate is essentially a price control that prevents builders and subsequent owners from selling or leasing at market prices. This holds for rental and for-sale housing. Congress Member Farr's proposed quota would restrict market prices and mandate that builders sell or lease 50 percent of their units at below-market rates. Rather than helping, the affordable housing mandate will decrease the value of the land and revenue for the government significantly. If the controls are too great, they will prevent development completely.

Imposing costly housing regulations would not cut into some exorbitant profit rate of a developer, but would simply decrease what F.O.R.A would receive for the land. On Fort Ord the high cost of environmental cleanup, demolition, and infrastructure already make the project economically challenged. As the regulations become more burdensome, they will push the price of the land down closer to zero, and at some point the value can become negative. In other words, developing would be so costly that the government would need to subsidize builders just to take on the project.

How much the government reduces incentives depends on how many restrictions they impose. As the affordability quota becomes more restrictive, fewer homes will be built. An affordability quota of 1 percent would be much less restrictive than an affordability quota of 100 percent. Current regulations already mandate that 20 percent of the new housing in Fort Ord be sold or leased at below-market rates. This creates distortions and inefficiencies, but does not create nearly as much harm as if government increased the affordability quota to 50 percent.

We interviewed builders to get estimates of the costs of developing 6,000 units of housing on Fort Ord and then estimated the expected costs of the price controls. We estimated average total revenues, costs, and residual land values for the entire Fort Ord project under three different affordable housing quotas. We provide estimates for a base line situation where all units could be sold at market prices, a second situation where the current 20 percent affordability quota is enforced, and a final scenario where Congress Member Farr's suggested 50 percent quota is imposed. These estimates are all based on a total of 6,000 units for sale, and the assumption that builders need an 8 percent profit on the revenue from sales.

Table 2 estimates builder revenue from sales under the three different affordability requirements. The sale prices of market-rate homes are an estimated average for the entire development. The controlled prices are the price maximums required for the units to be affordable income levels in Table 1.

TABLE 2. TOTAL REVENUE FROM FORT ORD HOME SALES				
	# Units	Avg Price Per Unit	Total Revenue	
<u>No "Affordable" Requirement</u>				
Market Rate Homes	100%	6,000	499,920	
Total Scenario 1 Revenue			2,999,520,000	
<u>20% "Affordable" Requirement</u>				
Market Rate Homes	80%	4,800	495,879	2,321,892,600
Work Force Homes	0%	0		
Moderate Income Homes	8%	480	227,000	108,960,000
Low Income Homes	6%	360	123,817	44,574,120
Very Low Income Homes	6%	360	88,440	31,838,400
Total Scenario 2 Revenue			2,565,591,720	
<u>50% "Affordable" Requirement</u>				
Market Rate Homes	50%	3,000	483,756	1,378,446,300
Work Force Homes	10%	600	301,000	180,600,000
Moderate Income Homes	20%	1,200	227,000	272,400,000
Low Income Homes	10%	600	123,817	74,290,200
Very Low Income Homes	10%	600	88,440	53,064,000
Total Scenario 3 Revenue			2,031,622,200	
Notes:				
1. Assumes all Units are for sale.				
2. Sale price per County Ordinance & proposed General Plan Housing Element				
3. Percentages under 20% Requirement are per County Ordinance				
4. Percentages under 50% Requirement are per Farr's proposal				

Unsurprisingly, when all units can be sold at market-rates, the sale of homes generates far more revenue. Compared to the current 20 percent requirement, we estimate that implementing Congress Member Farr's proposed 50 percent affordability quota would decrease revenue in the project by more than **\$500 million**. Compared to a situation with no price controls, the 50 percent requirement decreases the revenue from the development by nearly \$1 billion.

Builders may be able to partly offset the losses from the requirements by building apartments to meet the requirement for very low-income housing. If they did this and received a 9 percent tax credit, their revenue per unit from selling the very low-income apartment buildings could be as much as \$200,000. While this would help slightly, it would not much change the overall picture. Revenues would still drop by \$500 million.

Table 3 estimates average builder costs under the three different scenarios and uses them to compute the price builders would be willing to pay the government for the land. The land residual is calculated by subtracting total costs and builder profit from the revenue. The land residual is our estimate of the total revenue that the government could

receive from builders for the sale of the land. In addition to usual builder costs, redevelopment of Fort Ord entails considerable additional outlays.

TABLE 3. LAND RESIDUAL VALUES WITH VARIOUS "AFFORDABLE" HOUSING QUOTAS						
	0% "Affordable"		20% "Affordable"		50% "Affordable"	
	Total	Per Unit	Total	Per Unit	Total	Per Unit
Revenue	2,999,520,000	499,920	2,565,591,720	427,599	2,031,622,200	338,604
Costs						
Professional Fees	83,990,400	13,998	75,311,834	12,552	64,632,444	10,772
Intract Land Improvements	192,000,000	32,000	168,000,000	28,000	156,000,000	26,000
Building Construction	973,894,000	162,316	928,345,200	154,724	874,797,000	145,800
Landscape/sitework	48,000,000	8,000	48,000,000	8,000	48,000,000	8,000
Indirects	104,983,200	17,497	89,795,710	14,966	71,106,777	11,851
FORA Fees	218,865,000	36,478	218,865,000	36,478	218,868,000	36,478
Fees at Building Permit	126,000,000	21,000	126,000,000	21,000	126,000,000	21,000
Warranty	29,995,200	4,999	25,655,917	4,276	20,316,222	3,386
Marketing and Sales	149,976,000	24,996	128,279,586	21,380	101,581,110	16,930
Property Tax, HOA, Financial	239,961,600	39,994	205,247,338	34,208	162,529,776	27,088
Administrative expense	112,482,000	18,747	96,209,690	16,035	76,185,833	12,698
Total Costs	2,280,147,400	380,025	2,109,710,275	351,619	1,920,017,162	320,003
Builder Profit @ 8%	239,961,600	39,994	205,247,338	34,208	162,529,776	27,088
Land Residual	479,411,000	79,902	250,634,108	41,772	-50,924,738	-8,487
Notes:						
1. Intract costs are lot improvement expenses and do not include demolition or environmental clean up						
2. All backbone infrastructure is assumed to be completed by FORA and land developer. These are costs that will have to be paid for out of the Land Residual.						

Although revenues decrease dramatically with increases in price controls, costs do not decrease nearly as much. Revenues decrease by 21 percent as the affordability quota is raised from 20 percent to 50 percent, but costs decrease by only 9 percent. These estimates show that without a massive subsidy from the government, builders would not undertake the development of Fort Ord at all if the proposed 50 percent affordability quota were imposed.² **Imposing the 50 percent quota would require the government to pay developers approximately \$50 million and give them the land for free just to entice anyone to build.** Alternatively, if affordability controls were left at the current 20

² These estimates are contrary to the unsubstantiated assertion of the Executive Director of *Land Watch Monterey County* who wrote, "There is absolutely no reason to believe that establishing a 50 percent affordable housing requirement, as recommended by Congress Member Farr, will result in 'zero' development." (Patton, Gary, "LandWatch Supports Farr Affordable Housing Recommendations" July 5, 2003, Accessed at www.mclw.org on 10/30/2003) We were unable to find the reasoning on which he reached his conclusions.

percent, builders would build the entire 6,000 units and would pay the government as much as \$250 million for the land.

In the scenarios, the average cost per home ranges from \$320,000 to \$380,000. These figures do not include the price of the land, environmental cleanup and backbone infrastructure. If government requires 50 percent of the homes to be sold for an average price of \$193,000, this will not cover the costs of construction. Builders would need to be given the land and paid more than \$50 million just to cover costs.

The costs in Table 3 do not include the additional environmental cleanup and development of backbone infrastructure that will be required on Fort Ord. Revenue from the sale of the land can help cover these costs, but if the 50 percent “affordability” regulations push the value of the land below zero, that money will no longer be available. Environmental cleanup and backbone infrastructure expenditures vary for different developments but are quite significant. For example, one planned development in Fort Ort, University Villages, would have 1,200 residential units. In the residential portion of University Villages, estimates of clean up expenses are around \$40-\$60 million and backbone infrastructure expenses are around \$44 million.³ Assuming these estimates are representative for the entire 6,000 unit redevelopment, total cleanup and backbone infrastructure costs would be \$440-\$520 million. Cleanup costs for contamination may be greater in other areas, so the total costs may be greater. Either way, if the affordability quotas were increased to 50 percent, revenue from the sale of the land would be negative and money would have to come from elsewhere for F.O.R.A. to cover costs.

If builders receive a 9 percent tax credit and build apartments to meet the very low-income housing requirement, the numbers would change slightly, but the overall outcome is similar. Land value with the 20 percent requirement would be approximately \$278 million, but with the 50 percent requirement, the land value would become negative. Builders would need approximately a \$5 million subsidy, along with government provision of backbone infrastructure and free land, in order to be encouraged to undertake the development.

We want to be clear that although a 20 percent affordability quota is better than a 50 percent quota, a 20 percent quota is not the ideal policy. Our estimates show that if the price controls could be entirely eliminated, 6,000 units could be built and F.O.R.A. could raise almost \$480 million from the sale of land. Some argue that since the land was given to the government “for free,” the government incurs no costs from establishing price controls. This belief fails to take account of the lost revenue from land sales that result from increasing price quotas. The difference in revenue generated from the sale of land with a zero percent quota versus a 20 percent quota is more than \$200 million.⁴

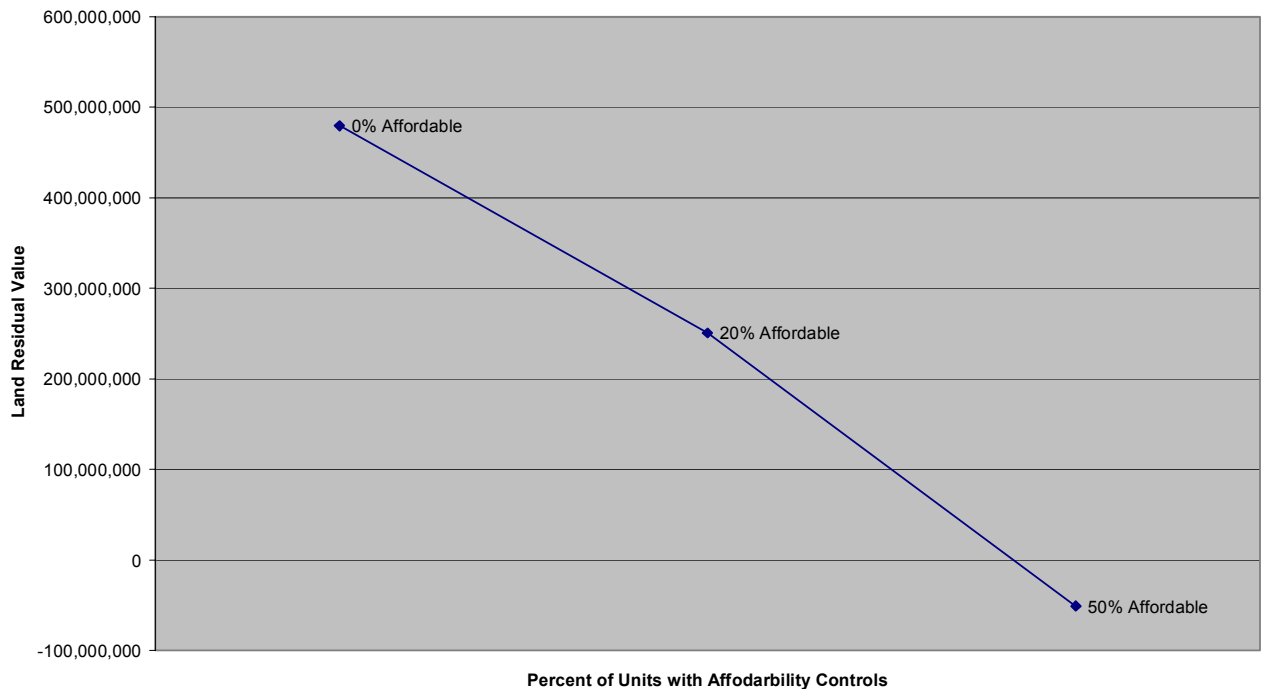
³ These estimates are above and beyond the clean up paid for by the F.O.R.A. fees.

⁴ Garry Patton of *Land Watch Monterey County* wrote, “While there are definitely ‘cleanup’ and ‘infrastructure’ costs on Fort Ord, the land is essentially ‘free.’” He and others fail to realize one of the most basic laws of economics, that there are opportunity costs to all actions. Even if he were correct when he wrote, “This is some of the most valuable real estate in the world, and if FORA tells developers that they have to meet a higher ‘affordable housing’ standard than they do elsewhere, they will meet it (or not develop),” the fact remains that increasing the affordability controls destroys asset value and costs the government revenue. (Patton, Gary, “LandWatch Supports Farr Affordable Housing Recommendations” July 5, 2003, Accessed at www.mclw.org on 10/30/2003)

These valuable funds could be spent on improving public services in the Fort Ord community. Without such improvements, fewer employers will be attracted, and less job creation will occur in the base.

Fundamentally, every increase in affordability requirements destroys the value of the asset, the land on which development can be built. Since government owns the land in Fort Ord, it will bear the costs of decreasing the land value. Figure 1 shows the estimated revenue from the land value that could be generated for the government under the three affordability quotas and graphs the approximate values of the land with other quotas in between them.

FIGURE 1. LAND SALE REVENUE AS "AFFORDABILITY" CONTROLS INCREASE



Any increase in the affordability quota beyond zero translates into lost revenue for F.O.R.A. Although the F.O.R.A. board may not have the authority to reduce the quota to zero, we should realize any increase in the affordability regulations is a step in the wrong direction. The government should set the affordability restrictions as low as possible. This will minimize the destruction of asset value and minimize the loss in revenue for government. Any movement in the wrong direction will destroy value and jeopardize the feasibility of the project.

Local governments will also lose annual revenue because of price controls. Because the “affordable” housing requirements restrict the value of homes, local government will lose significant tax revenue for all future years. Those who argue that

affordable housing requirements have no cost fail to see the opportunities lost due to the regulations. The lost tax revenue is money that could be spent on other public programs to benefit the community, including programs that benefit low-income families. The price controls will create a strain on local governments to provide services such as police and fire due to lower revenue from the lower property taxes. It may leave the local government with revenues that are less than the cost of services. Governments will have to tax the rest of the community more heavily or cut back services. Table 4 estimates the annual tax revenue that local governments would collect from the Fort Ord redevelopment under the various affordability criteria. Table 4 assumes that the land is sold to individuals and/or for profit management companies; relaxing that assumption will mean the resultant decrease in tax revenue will be even greater since not-for-profits will not pay those same taxes.

These estimates show that Congress Member Farr’s proposal would cost the local governments at least \$5 million in annual tax revenue if implemented. That lost revenue could go to helping low-income families through other programs. Local governments will lose some of the tax increment. The tax increment is money that comes from the state based on the increase in assessed land value. The decrease in assessed valuation will reduce the available tax increment. Increasing “affordability” quotas from 20% to 50% will cost approximately \$2.5 million in lost tax increment per year. If bonds backed by cash increment revenue were issued to make improvements in Fort Ord the total lost funds would be between \$30 million and \$40 million.⁵ The tax increment funds that are lost will put further strains on F.O.R.A. to come up with enough money to make the

	0% Affordability Quota	20% Affordability Quota	50% Affordability Quota
Average Home Value	\$499,920	\$427,599	\$338,604
Number of Homes	6000	6000	6000
Total Assessed Value	\$2,999,520,000	\$2,565,591,720	\$2,031,622,200
Tax Rate	1%	1%	1%
Annual Tax Revenue	\$29,995,200	\$25,655,917	\$20,316,222

Note: With 50% affordability requirement this assumes that a subsidy is given that will encourage builders to develop Fort Ord. Without subsidy the annual tax revenue would likely be zero because the builders would not buy the land and develop it.

development viable.

3. The Economics of the Housing Market and Affordability Controls

We can see the costs of the price controls are large. Let us explain the economic theory behind the results. In the free market, housing prices are determined by supply and demand, but under the proposed affordable housing program the local government

⁵ These numbers assume that a bond could be issued backed by tax increment revenue with 5% interest and that the tax increment revenue would last from 20 to 30 years.

regulates prices. Compelling builders to sell for below-market rates will have all the traditional effects of price controls, and nearly all Ph.D. trained economists agree on the issue of price controls.⁶ By analyzing the proposed price controls at Fort Ord, one can predict the consequences of Congress Member Farr's proposal.

The most important principle for advocates of affordable housing quotas to understand is the following: at lower prices, builders will provide a lower quantity and lower quality of housing. The important point to realize is that builders have costs, and they decide to develop property based on the expected revenue and expected costs. The law of supply tells us that if government restricts how much builders can charge, less investment in housing will occur than if government allows prices to adjust to market conditions. Since affordable housing quotas lower revenue and make development less profitable, one should expect to see a lower quantity of housing provided as regulations increase. Consider the example of one developer in Windsor, CA:

Orrin Thiessen, the architect and developer behind downtown Windsor's transformation, said if he is required to build affordable units along with his market-rate town houses, it could put him out of business. "That'll kill some of my projects," he said. "I'm buying land at very high prices and building very expensive buildings on top of it. It's pretty simple from my perspective. It just doesn't pencil out."⁷

The greater the restrictions on price, the lower the quantity supplied, and at some point builders are unable to afford to build at all. Restricting how much builders can charge will lead to less housing, not more. In the resale market and the for lease market, the principles are the same. At lower prices a lower quantity of housing will be supplied for resale or for lease. In the long run, the quality of the existing housing stock will decline as it ages and is not replaced.

A lower quantity of housing supplied is only the beginning of the problem. The next basic principle, known from the law of demand, is that at lower prices, buyers will want to consume a higher quantity of the good. As the price of housing is lowered, residents will demand more housing. Rather than sharing living arrangements, more people will choose to live alone and/or in bigger units.⁸ When the relative price of buying becomes lower, it encourages more renters to want to become buyers. Those who have access to housing at the low price will consume more than they would if they had to pay a higher price. Analyzing the interaction between buyers and sellers, one can see that setting the price of housing below-market creates a shortage where quantity of housing demanded exceeds the quantity supplied (See Figure 1). To give an example, if the law mandated that all homes be sold at 50 percent of market price, many people would demand the units but few people would supply them. The less restrictive the mandate, the

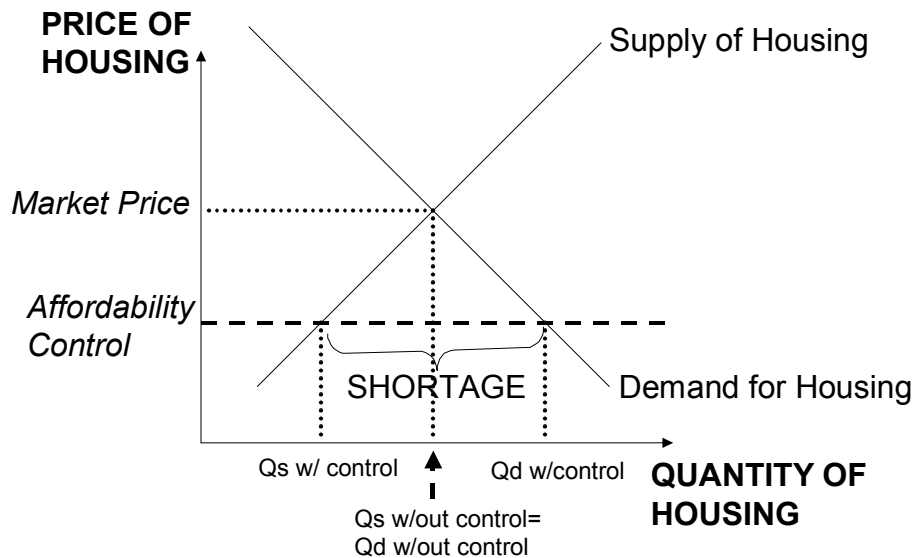
⁶ A poll conducted of more than 200 Ph.D. economists from all political perspectives found that 98 percent agreed that ceilings on price, "reduces the quantity and quality of housing available." Block, Walter (2003:¶5) "Rent Control" *The Concise Encyclopedia of Economics*. Ed. David R. Henderson. Indianapolis: Liberty Fund, Inc.

⁷ Mason, Clark (2003) "Windsor may bend rules for developer." *Press Democrat*. October 17, ¶¶2-3.

⁸ Economic research has shown that when housing prices are restricted below-market price, residents, including single men, use more rooms than they would have otherwise. Block, Walter "Rent Control" *The Concise Encyclopedia of Economics*. Ed. David R. Henderson. Indianapolis: Liberty Fund, Inc.

smaller the shortage. But to the extent that prices are pushed below market, a shortage will exist.

FIGURE 2. SUPPLY AND DEMAND OF HOUSING WITH AFFORDABILITY CONTROLS



When quantity demanded exceeds quantity supplied, the available units have to be rationed, in which case a lucky few get the units while everyone else is left out. A number of studies show that restricting housing prices to below-market rates creates a situation in which only a few people can find units at the low price, which of course does not benefit the majority of the consumers. For example, the affordable housing complex *Rich Sorro Commons* by San Francisco’s Pacific Bell Park had 2,700 applicants for only 100 units. A family had to be fortunate enough to be living in the city, apply, and then win a lottery to get one of the 100 units.⁹ The other 2,600 families, as well as low-income families who were unable to apply, do not benefit from programs that give benefits to a select few. If the goal is to help low-income families, why give benefits to a concentrated few and create shortages when other programs not tied with new construction housing could be used to benefit all?

One need not look far to find examples of the laws of economics at work in the housing market. In 1990 the city of Watsonville passed a law requiring that 25 percent of all new homes be sold to low and moderate-income buyers. The effects of that policy illustrate exactly what the laws of economics predict. Between 1990 and 1999, with the exception of a few small non-profit developments, almost no new construction occurred. The law was finally revised in 1999. In the words of Watsonville Mayor Judy Doering-Nielsen, “There was an incredible pent-up demand. Our inclusionary housing ordinance

⁹ Stoll, Michael (2002) “Mission Bay Takes Shape,” *San Francisco Examiner*, September 13, 2002.

was so onerous that developers wouldn't come in.”¹⁰ Jan Davison, the city's redevelopment and housing department directory commented “It [the inclusionary zoning law] was so stringent, and land costs were so high that few units were produced,” but then “It was completely redone in 2000, and we got more units produced.”¹¹ The change in 2000 was to lower affordable housing requirements from 25 percent to 20 percent for larger developments and to lower it to 15 percent for developments with between 7 and 50 units. After almost a decade with no new developments, a 114-unit development, a 351-home development, a 389-unit development, and a number of smaller developments began construction after the lowering of affordable housing requirements. Overall, the number of projects approved and pending approval since 2000 is set to increase the city's housing stock by 12 percent. All of this development occurred with just a slight decrease in affordable housing requirements. If affordable housing laws were further rolled back, economics tells us that even more units would come to market. The same laws of economics that caused affordable housing regulations to restrict the supply of housing in Watsonville operate in the Fort Ord redevelopment. Any increase in the affordable housing quotas will have an adverse effect on the quantity of housing supplied.

A common error made when considering the impact of the price controls on homes is failing to consider their impact on the margin. Some advocates of affordable housing quotas assume that profits per house are excessive and conclude that reducing profitability will not decrease investment in housing. This type of analysis completely misunderstands how profits function in a market economy. They miss the simple fact that the more profitable an industry, the more investment the industry will attract and that such above-normal profits cannot persist. In a free market, above-normal profits attract entrants into an industry to earn some of those profits. This process pushed prices and profits down. For example, suppose the normal pretax builder profit margin is between 7 and 10 percent, but due to pent-up demand the rate of return in the housing industry is 33 percent. Economics would predict that a 33 percent rate of return would attract so much investment and competition that the new entrants would eventually bring the profits in the industry down to 32 percent, then to 31 percent, then to 30 percent, and so on until the profit rates returned to the normal 7-10 percent profit margin. Consistently above-normal profits are essentially a green flag for new investment in an industry. It will attract new entrants eager for a share of the market who will undercut the incumbent firms, thereby lowering prices and profits. Desiring to sell as much as possible, new entrants will bid for resources and further decrease profits. As long as government does not restrict competition, this competitive process will push above-normal profits down until

¹⁰ Terri Morgan, “Loosened Rules Lure Developers to Watsonville” *San Jose Mercury News*, Sat Oct. 18, 2003. Interestingly many advocates of affordable housing miss this completely. Bay Area Economics (2003:15) wrote, “The City of Watsonville adopted its inclusionary housing ordinance in 1991. To date, the program has directly created only thirteen affordable units. However, this low number is attributable to the lack of new development in Watsonville over the last 10 years.” (*The City of Salinas Inclusionary Housing Program Feasibility Study* (2003) Berkeley: Bay Area Economics) The “however” in the above sentence is very telling. Bay Area Economics treats the lack of development as something that has no connection to the price controls. By ignoring the most important variable, namely price, it is easy to absolve price controls as the culprit that drove out builders.

¹¹ Terri Morgan, “Loosened Rules Lure Developers to Watsonville” *San Jose Mercury News*, Sat Oct. 18, 2003.

consumer demand is satisfied.¹² If one looks at actual builders, one can observe that their builder profits are in the neighborhood of 7-10 percent, not 33 percent.

Suppose the construction of a specific house costs \$300,000, the land costs \$100,000, and the developer could resell the house for \$600,000, thus earning 33 percent in developer profits. Economics predicts that so many firms would want to earn that profit, that they would bid up the price of the land until it was around \$240,000, making builder profit 10 percent. Builders would not seize the extra high profits from the high demand for housing; the gain would go to the holder of the land, in our case Fort Ord Reuse Authority. If landowners begin earning large returns by selling their land, other landowners will want to sell their land as well. This will push land prices down and supply more land that can be used for housing. If, on the other hand, the price of land is restricted, landowners would be more likely to use their property in lower valued uses such as parking lots. For any good, including land and housing, if we want to encourage more supply government should allow prices to adjust rather than imposing price restrictions.

4. Benefits to the Community of Improvements in the Housing Stock

Congress Member Farr's proposed increase in the affordable housing mandate will create an even worse shortage than exists today. Under the free market, price is allowed to adjust so quantity supplied can equal quantity demanded, enabling families to find housing more easily. But with a housing shortage created by price restrictions, housing is more difficult to find and this leads to a number of problems. One major problem for working families is decreased mobility for workers. People often choose their residence based on proximity to their job. If, due to an artificial shortage, they cannot find housing within a reasonable commute, their choices of employment will be reduced. This harms both those with and without the below-market units. Those fortunate enough to get one of the cherished below-market units are unlikely to give it up and move elsewhere. If offered a better job outside driving distance of Monterey, they would be less likely to accept it. This means more workers will end up in less fulfilling jobs close to their housing than under a free market where shortages are eliminated. Such policies decrease upward mobility for those who need it most.

What should there be instead of restrictions on housing prices? Rather than discouraging the production of housing, government should encourage housing by allowing market prices and removing impediments for production. The late economic commentator for *Newsweek*, Henry Hazlitt, explained that actually “the cure for high

¹² Rawson *et al* (2002) acknowledge that restricting the returns on investment may destroy profitability completely, and so they believe there should be cases where builders are given waivers for inclusionary zoning. But they believe this should be given only in the most extreme cases. They argue, (p.15) “However, the test for determining economic hardship also should be strict – that the developer would be deprived of all economically viable use of the land (not that the developer’s profit margin would be reduced).” (Rawson, Michael *et al* (2002) *Inclusionary Zoning: Policy Considerations and Best Practices*.” California Affordable Housing Law Project of the Public Interest Law Project: Sacramento, CA.) But they misunderstand the most basic function of profits. Whenever profits are reduced by such policies it necessarily will decrease the attractiveness and the amount of investing in housing. Why would investors put their capital in real estate when they can put their money in other sectors without price controls?

prices is high prices. High prices lead to economy in consumption and stimulate and increase production. Both of these results increase supply and tend to bring prices down again.”¹³ Allowing market prices will lead builders to build more, and an increase in the long run supply leads to lower prices. But if government restricts how much builders can charge, less housing will be built. Economics tells us that restricting the supply will actually lead to higher housing prices, the exact opposite of the result the advocates of the affordable housing quota hope for.

Consider how these types of price restrictions would affect other markets. A 1983 Chrysler Minivan is so affordable because someone paid a lot of money for the vehicle twenty years ago.¹⁴ But if government always had price restrictions on Chrysler Minivans, the vehicles would never have been built in the first place. Allowing Chrysler to sell cars at high prices to those who can afford them benefits everyone by increasing the quantity of vehicles available to others. For every new car produced, a high-income person upgrades and trades in his or her old car. This frees up a used car for someone else. The same is true for housing. Every time a high-income family buys a new house and sells its old one, it frees up a house for someone else.

Imagine what would happen if the government imposed below-market price restrictions on automobiles. Even though the goal would be to increase the number of cars available to low income households, it would have the opposite effect. Manufacturers have costs and will simply not bring the product to market if they are told they must charge below cost. This would harm both high and low-income individuals alike. The high-income individuals would no longer have their new cars, and low-income individuals would no longer have the benefit of buying high-income individuals’ used cars.

The laws of economics hold in the market for housing just as in the market for cars. If government restricts the prices builders can charge, they will provide fewer units. This will harm everyone. Consider a hypothetical town with only two homes and three families of different income levels. The high-income family starts with a nice old home, the middle-income family starts with a midrange home, and the low-income family shares a home elsewhere, an undesirable situation. When new land becomes available, what type of home should be built? The low-income family clearly needs housing, so one might assume the best solution is to set aside the land for them. But economic logic shows us that, paradoxically, setting the land aside as affordable housing can easily make everyone, including the low-income family, worse off. Let us consider how.

Advocates of affordable housing usually only look at what is created under their program and fail to consider what was not created because of the program. An article in *Real Estate Issues*, “Mixed-Income Housing: A New Direction in State and Federal Programs,”¹⁵ makes this clear; the only measure of accomplishment is that the programs required affordable homes to be built. Likewise, *California Affordable Housing Law*

¹³ Hazlitt, Henry (1993) *The Wisdom of Henry Hazlitt*, Ed. Hans F Sennholz. Irvington-on-Hudson, NY: Foundation for Economic Education.

¹⁴ Economist David Henderson of the Naval Postgraduate School gives us this analogy.

¹⁵ Hoffman, Morton (1995) “Mixed-income housing: A new direction in state and federal programs,” *Real Estate Issues*. August; 20, 2: 40-46.

Project's "Inclusionary Zoning: Policy Consideration and Best Practices" includes twenty-four pages on how the affordability requirements can be imposed and less than a page on their Measure of Success.¹⁶ The only measure is that the policies should be imposed, enforced and then tracked by government. But the mere fact that a policy is imposed does not mean it is successful and certainly does not mean it is worthwhile. These advocates fail to consider costs of the project or how many homes were not built because of the mandate.

In our hypothetical example of the three-family town, requiring that the land be developed with affordable housing will lead to one of two results: either builders build or they do not. If no home is built, the situation is undoubtedly not improved, but when an affordable home is actually built, is it an improvement? The proper comparison is not between no home and a home built with price controls but between what would be built with the price controls and what would be built without. By making this comparison we can see that an affordable housing quota can actually make all parties worse off. The simplest way a developer can meet the expense of selling a house for \$130,000 is to adjust quality and size downward until the cost of the homes is slightly less than \$130,000.¹⁷ Let us compare the outcomes. If the builder builds a \$130,000 home for the low-income family, the high-income family will stay in their old nice home and the middle-income family will stay in their old midrange house. The situation is an improvement compared to one where no home is built, but it is actually inferior to a situation where a new market-rate home is built and all three families get to upgrade.

If the high-income family could move into a nice brand new home, they would move out of their nice old home, which would free it up for the middle-income family. Due to the housing stock being improved, the price of the nice old home will become lower, which enables the middle-income family to upgrade. Since the high-income family will be the highest bidder on the nice new home, and no longer be the highest bidder on the nice old home, the middle-income household becomes the highest bidder on the nice old home. When the middle-income family moves into the nice old home their situation improves and they free up their midrange home for the low-income family. A situation with a nice new home, a nice old home, and a midrange home is superior to a situation with a nice old home, a midrange home, and a low-end new home. The cost of having the new low-end home is not having the new high-end home and not having all families benefit.

Obviously more than three families live in Monterey County but the principles of the hypothetical three-family town will be exactly the same for the Fort Ord Redevelopment. We have to realize that building a below-market home displaces a family who wanted to pay the market price and prevents everyone from improving their living situation. If six thousand California residents move into market-priced homes at Fort Ord, they will vacate upwards of six thousand homes. The families who purchase the 6,000 vacated homes will be moving out of near that many as well. Regardless of the

¹⁶ Rawson, Michael *et al* (2002) *Inclusionary Zoning: Policy Considerations and Best Practices*." California Affordable Housing Law Project of the Public Interest Law Project: Sacramento, CA.

¹⁷ The price of a home would have to be restricted to \$120,000-130,000 for it to become affordable to low-income families earning 50-80 percent of the median income. (Farr, Sam (2003) "Recommended Policies for Adoption by FORA" p.2)

length of the chain, this increase in the supply of housing will free up housing and push prices down for all groups. On the Monterey Peninsula, even housing in disrepair fetches such high prices because these homes are often the best ones available to high-income households. But if we improved the housing stock on the upper end, middle-income households will benefit by having the now mid-range homes available to them and all the way down the line.

A classic study, *New Homes and Poor People*, looked into the chain of existing home sales in 13 different cities and found that each new home generated an average of 3.5 moves.¹⁸ All of those moves increase the supply and lower the price of existing homes, thus making them more affordable for low-income buyers. This study also found that lower income brackets benefit from this chain of sales created by market priced new construction. The study reports that between 9 percent and 14 percent of all movers were low-income. The effect on moderate-income families is even stronger. In moves after the first new construction move, people of moderate income made up 30 percent of movers. The study's overall finding was, "Any policy which increases the total supply of housing will be beneficial. The working of the market for housing is such that the poor will benefit from any actions which increase the supply in the total market" (p. 68).

Adjusting for inflation and for Monterey County income levels, we can create a rough estimate of the chain of moves generated from the development of market priced housing at Fort Ord. If the entire development could be sold or leased at market prices, we estimate that from 6,000 new construction units, a total of 21,000 moves could be generated. Even if only high-income families moved into the new construction, all income groups would benefit. According to our estimates, approximately 5,500 households with an income between \$23,500 and \$47,000 would move to a different home, and approximately 2,700 people with an income of less than \$23,500 would move. These income groups are similar to those classified as "very low" (<\$28,550) and "Low" (\$28,550-\$45,680) in Congress Member Farr's affordable housing recommendation. Congress Member Farr recommends 10 percent of Fort Ord new construction go to households with incomes classified as very low and 10 percent of units for households classified as low. That would require 600 units to be sold to people in each of these two categories (assuming the entire development is 6,000 units). Our estimates indicate that the natural chain of moves following from market priced homes would allow far more than just 1,200 people in the "very low" and "low" income categories to move. Even more low-income families in Monterey County could move if tax revenue from market priced homes in Fort Ord were used to help low-income residents afford housing. Table 5 contains our estimates for the number of moves that could be generated and how many lower-income families could be expected to benefit from allowing Fort Ord to be developed at market prices.

¹⁸ Lansing, John, Clifton, Charles and Morgan, James (1969) *New Homes and Poor People*, Ann Arbor, MI: Institute for Social Research.

Total new construction built	6000
Total moves into new and existing homes generated by construction	21000
Moves by families with Incomes between \$23,500 and \$47,000	5520
Moves by families with incomes below \$23,500	2730

Not all chains of sales are the same length and more or fewer people may benefit. Many variables contribute, but the price of a new home increases the length of the chain and allows more people to benefit. If higher priced new construction is built, it will benefit the high-income families who move into it, the middle-income households who move into their old homes, and the low-income households who move into the middle-income families' old homes. Six thousand market priced units at Fort Ord would benefit all housing consumers and improve affordability. But if the price of new housing is restricted with affordable housing regulations, average income families and others who would usually benefit from upgrades in the chain of moves generated by new construction are cut out of the process. Assuming builders still build, a 50 percent affordable housing mandate in Fort Ord would prevent most families in Monterey County from benefiting from the new construction.

Many advocates of affordable housing recognize that government should not encourage inferior housing but instead want high quality-homes produced. They wish to mandate that the developer build expensive homes but sell them at below-market rates. The Public Interest Law Project's *California Affordable Housing Law Project* states:

Inclusionary units should retain the same basic amenities as the market-rate units. In addition to size and location, inclusionary units should also possess the same basic amenities as the market rate units in the development. Again, these requirements serve to discourage the stigma and 'ghettoizing' of the affordable units.¹⁹

In such a situation we hope for the best of all worlds, new high-quality homes that would go to low-income families. But the problem with this reasoning is that the housing will not be produced if the builders are forced to sell homes below cost. Capital will not be available to builders if an insufficient return on investment exists. In this case we are back to square one. Government either makes builders build lower quality homes, or requires them to sell at a loss. Both of these policies will harm the stock of housing and prevent development.

5. Affordability Price Controls and Low-Income Households

Advocates of affordability quotas fail to recognize that their programs lead to a lower quantity of homes being built and displace families who could have bought at market prices. A more sophisticated advocate of affordable housing quotas might recognize the high costs but still believe that helping a few low-income families is worth

¹⁹ Rawson, Michael *et al* (2002) *Inclusionary Zoning: Policy Considerations and Best Practices.* California Affordable Housing Law Project of the Public Interest Law Project: Sacramento, CA, p.12.

it. Even with inefficiencies, as long as the programs can help even a few, believe some advocates, perhaps government should pursue the policies nevertheless. Despite the stated intent of this position, economics tells us that price controls are an ineffective method of helping the very people we are most concerned about.

One of the main problems with price controls is that the units are available only to a select few. Residents must fall within income guidelines and go through the bureaucratic process of qualifying to move into a regulated home. Everyone else is left out. The shortage created by price controls in turn creates spillover affects in the market for non-regulated units. Because homes that would have been offered at market price are regulated to affordable housing, fewer market-priced homes are available. This displaces families from potential market-priced homes and drives up the cost of housing for all market-rate homes. This creates an affordability problem for families who are squeezed out of the market. They have to stay in their older homes while low-income families take the new homes. These displaced families are being totally forgotten. The affordability quota introduces a two-tiered housing market: one market with price controlled units, and the other with more expensive housing that now can be afforded only at higher incomes. Is it fair that a select few benefit at the expense of pricing out others in the same demographic and income group?

Providing homes at below-market rates also gives long-term benefits to some who may only need short-term help. Housing is a long-term commitment, but income is not static and varies throughout the course of a lifetime. Affordable housing programs do not target low-income families in future periods; instead, they target only households that are currently low-income. This is an ineffective means of helping low-income households. Most people have lower incomes in their twenties and thirties (at the beginning of their careers), higher incomes in their forties and fifties (at the peak of their careers) and then higher wealth but lower annual income in retirement.²⁰ But the affordability requirement misses all of this. People at the start of their career may be low-income and qualify for an affordable unit today, but may be making much more money later on. But, given the nature of the affordability controls, those who receive the affordable units will be able to keep their below-market housing payments even after they are in higher-income brackets.

Data show that although some people remain at low income throughout their life, most low-income households move into higher-income categories as time moves on. University of Michigan Panel Survey on Income Dynamics data show that of those in the bottom 20 percent income bracket in 1975, only 5.1 percent of them remained in that lowest income bracket by 1991. In fact, 29 percent of the lowest fifth of income earners in 1975 had moved to the top 20 percent of income earners 1991. This means that price controlled units can continue to subsidize households for years by ignoring the fact that their incomes may increase. Programs aimed at helping low-income households should not be tied to long-term assets such as homes. The funds spent on affordable housing could be more efficiently targeted by tying subsidies to shorter term cash flows that will

²⁰ Many wealthy aged individuals have low income because they are retired but they own their homes and have low expenses. But aggregate "Housing Needs Assessments" about income and housing affordability would mistakenly classify them in the category of low-income families in need of a home, e.g. *City of Salinas Inclusionary Housing Program Feasibility Study*, Berkeley, CA: Bay Area Economics, p.i.

not remain as a person moves through their lifetime earnings cycle and on to higher incomes.

Even those who are able to purchase the below-market units receive but a few of the many benefits of homeownership. The perverse incentives of the program will lead families to live in their homes longer than optimal, which will further prevent families in need from being able to move into the units. Many people sell their first starter home and move to larger homes as their earnings increase over their lifetime but price controls create incentives for families to stay in their homes long after they need them. One of the main benefits of homeownership is building equity in a home that can appreciate in value. Unfortunately, affordable-housing mandates remove this benefit. The government can only guarantee that the units retain low prices by restricting the price at which the homes can be resold. “In order to ensure that affordable units remain affordable to the same income population for whom they were targeted, inclusionary zoning ordinances must include provisions for maintaining affordability for a specified period.”²¹ Oftentimes the affordability controls are imposed indefinitely. Unfortunately price controls limit the amount of appreciation and prevent the owners from gaining equity when they sell their home. This makes occupants of affordable housing much less likely to move because they would have to pay much higher market rates elsewhere. So even if incomes rise, a disproportionate percentage of those in affordable housing units will remain in them longer than they would choose otherwise.

By giving low-income families a benefit with so many strings attached, affordability controls are far less valuable than advocates of affordability controls usually consider. For many families, the value of their home is their most important asset; but price controls prevent appreciation and thus do not give low-income families the normal full benefits of homeownership. Appreciation creates wealth and helps owners afford to borrow against the value of the home for an investment or cash out to purchase another home. With capital appreciation taken away, they will be stuck with the home but little of its value. Homeownership is often considered the American dream; unfortunately homeownership with no potential of appreciation is not the same thing.

The only way to allow owners to gain from the appreciation in the value of their homes is to allow them to sell at market prices. One option would be to impose price controls at the initial sale and then allow the owners to sell at market prices later on. Here it would be clear that policymakers want to allow the recipients to benefit. But the obvious problem is that as soon as everyone sold at market prices the homes would no longer be “affordable.” It is hard to justify preventing the builder from selling at market rates but allowing the purchaser to cash out one month later with all the windfall gains. But by preventing low-income households from reselling the asset to others willing to pay more for it, government is giving low-income households tenuous benefits. Neither situation created by the price controls is desirable.

Since owners of restricted units will never be able to sell at market price, the incentives to maintain property are taken away, making it more likely that price-controlled units will deteriorate over time. Even the owner of run down property would

²¹ Rawson, Michael *et al* (2002) *Inclusionary Zoning: Policy Considerations and Best Practices.* California Affordable Housing Law Project of the Public Interest Law Project: Sacramento, CA.

still be able to find buyers at the legally mandated below-market price, and so owners of restricted units will lose much of the incentive for up keep. One of the benefits of homeownership, the potential for the sweat-equity gains of home improvement, is not given to owners of restricted units. And since their income is significantly lower than their neighbors, low-income families may not have the same disposable income to spend on repairs. This may lead to potential stigmatization, even if the homes look identical upon construction. Families occupying homes with price restrictions may not be able to capitalize on their hard work to keep their homes maintained.

6. The Effect on the Supply Caused by Special Burdens on the Housing Industry

We all agree that the goal is to help low-income households, but we must recognize that some ways are better than others. If two methods cost the same amount but one helps more, we should choose the one that yields greater benefits. Or, if two methods yield the same benefits but one costs less we should support the one with lower costs. An affordable housing quota is a clear example of an economically inefficient way of helping low-income households. For example, if a program costs \$1 million and provides \$100,000 in benefits to low-income households, the program is unmistakably inefficient. In such a situation nobody would be gaining that \$900,000, and everyone would be worse off. Instead of imposing this large cost on builders so low-income families can gain a little, a superior solution would be to allow builders to pay a cash transfer to low-income households by some amount more than \$100,000. Suppose the builders gave \$150,000 to a low-income family; that family would be better off because they would be gaining \$150,000 rather than \$100,000, and the builders would be better off because they would be losing \$150,000 rather than \$1,000,000. Such a situation is clearly more economically efficient since all parties are better off. Rather than creating an inefficient program that costs much more than it is worth why not give money for low-income households to use?

Some local governments have recognized the costliness of requiring builders to build affordable units, and so have adopted a compromise solution where builders can have an exemption by paying an in-lieu fee to a general housing fund. Proceeds from a general housing fund can be used to build new units elsewhere or can be given directly to potential buyers. An in-lieu fee is much less destructive because it does not force builders to lower the value of the development with low-priced units and it actually enables builders to afford to give more to low-income households. A housing fund can help put more low-income families in homes than if government required builders to build them homes, and so all parties would be better off. If low-income households can have more units built offsite, why should we support fewer units built onsite? Many cities such as Boston allow builders to pay an in-lieu fee instead of building the units themselves. We are not arguing that an inclusionary zoning requirement with an in-lieu fee option is the ideal policy, but it certainly is more efficient than the proposed onsite 50 percent affordable quota, since it allows builders to assist more low-income families than if they have to build the units themselves.

A newly constructed home is one of the more costly ways for a family to acquire a home. Since pre-existing homes are generally less costly, local government could help

many more low-income families by giving them money, deferred loans, or tax credits to move into existing housing. This could be financed with the extra revenue generated from market-rate homes. This policy would not destroy the value of a resource the way affordable housing does, and so a larger pool of money would be available to assist low-income families than would exist with inclusionary zoning laws. Inclusionary zoning regulations decrease asset value and are so economically inefficient that they are one of the worst means of providing affordable housing.

Some people might oppose an in-lieu fee option over the mandatory building for a few reasons. One is that it leads to low-income housing and high-income housing being situated in different areas. Advocates of inclusionary zoning basically want the government to plan and control the socio-economic makeup of neighborhoods rather than allowing individuals to decide in which type of neighborhood they want to live.²² But this belief must be recognized as a form of social engineering. If the twentieth century taught us anything, it was that markets are much better than government control at allowing people to live their lives. Advocates of inclusionary zoning want to force everyone to consume the same type of housing when in reality people have different housing demands at different stages of their lives. A person might want to live in a more urban condominium while young and single, then in a larger, more suburban house while middle-aged with a family. Contrary to the advocates of inclusionary zoning, not everyone wants to make the same choice and live in the same neighborhood.

Another reason people may oppose an in-lieu fee is that it makes the costs of affordable housing quotas more visible. One of the misleading arguments by those who support below-market rates is that their program has no costs to the public. For example, Burchell and Galley (2000) write, “this regulatory tool creates economically diverse communities and allows local governments to create more heterogeneous communities at little or no direct financial cost (Hill 1984; Smith et al. 1996, 170; Parrott 1999). Generally, the provision of affordable housing units as part of an inclusionary program does not require significant expenditure of public funds.”²³ Although the programs do not require financial expenditures by government, requiring builders to sell for below-market rates clearly imposes costs on builders. Again, most advocates of affordable housing fail to notice this cost and some even argue that it is beneficial to developers. Describing one such program in Maryland, Fischer and Patton (2001:2) write, “some developers in Montgomery County who were skeptical of the program at the outset are now among its most enthusiastic supporters.”²⁴ But one can arrive at such a conclusion only by ignoring the basic laws of economics. If the proposed building guidelines were really the most profitable for developers then there would be no reason to force developers to do what is in their best interest. The very fact that these programs are compulsory indicates that they

²² Tetreault, Bernard (2000) “Inclusionary Zoning: A Viable Solution to the Affordable Housing Crisis? Arguments Against Inclusionary Zoning You Can Anticipate Hearing,” *New Century Housing*, Vol. 1 Issue 2, October.

²³ Robert W Burchell and Catherine Galley (2000) “ Inclusionary Zoning: A Viable Solution to the Affordable Housing Crisis? Inclusionary Zoning: Pros and Cons.” *New Century Housing* Vol.1, No. 2. October.

²⁴ Paul Fischer and Jo Patton (2001) “Expanding Housing Options through Inclusionary Zoning” *Ideas at Work*, Vol. 3: 1-8.

are not profitable for builders. By seeing builders paying an in-lieu fee we can deduce that the costs of building affordable housing are significant.

This leads to two important questions. Why is government imposing this burden solely on builders and what affect will this have on the market for housing? Anyone, not just builders, could contribute to a general housing fund. When, then, should builders bear all of these costs? An *Innovative Housing Institute* (2000:19) publication responds, “No, they should not. But, like all segments of the community they have a role to play. And given that they produce the housing stock, and that the density bonuses alleviate any economic harm, the affordable housing requirement (like similar infrastructure and amenity requirements) is not an undue burden.”²⁵ But we must realize that when the government requires builders to pay to this housing fund, the government is essentially imposing a special tax on the housing sector. Affordability quotas are the equivalent to a tax on housing whether the government requires builders to actually build the units or requires payment of an in-lieu fee.

If we want to lower housing costs, the last thing government should be doing is imposing special taxes on the housing sector. When a special tax is passed in the housing industry, it does not come solely out of builder profits. It will lead to an effective restriction of supply and part of the taxes will be passed onto consumers. As one can learn from any principles of economics textbook, a special tax in the housing industry will lead to buyers paying more, sellers earning less, and fewer houses being built. This policy has the exact opposite effect than advocates of affordable housing want. The same results would occur if government imposed this burden on the manual laborers who build homes; even though they help produce the housing stock, imposing more burdens on the housing sector and increasing input prices only increases the price of homes to consumers. If the goal is to lower prices for consumers and increase the quantity of housing government should impose fewer burdens, not more.

In summary, the affordable housing requirement is costly to both builders and consumers. Anything that imposes costs on the builders of housing will impose costs on consumers of housing. Better ways of assisting low-income families exist. Instead of mandating inclusionary zoning, an in-lieu fee would enable developers to build more affordable housing at lower costs. Nevertheless, an in-lieu fee, although superior to an inclusionary zoning mandate, makes it clear that these programs have costs. Increasing the cost of building will lead to fewer and lower-quality homes constructed and higher prices to consumers. Therefore, government should think twice about imposing costs on the sector we are trying to help. Instead of destroying the value of the land with affordable housing regulations, the development at Fort Ord should be built and sold at market prices.

²⁵ Tetreault, Bernard (2000) “Inclusionary Zoning: A Viable Solution to the Affordable Housing Crisis? Arguments Against Inclusionary Zoning You Can Anticipate Hearing,” *New Century Housing*, Vol. 1 Issue 2, October.

7. An Alternative Way to Promote Affordable Housing

Housing prices in California are high. Finding inexpensive housing in Monterey County and other sought-after locations is particularly difficult. Many positive factors, such as the climate and the natural resources, contribute to the high demand for housing in the area. Overall, California has been one of the fastest-growing areas in the country for quite a long time. The growing population has increased the demand for housing, and prices have soared. Certainly making housing more affordable is a worthy goal that virtually all of us support. We have shown that regulations on price do not improve affordability. What, then, is the best way to bring more affordable housing to the region? In order to design the best policies to achieve affordability, we must first address why prices are so high.

The increase in population has undoubtedly increased the demand for housing in California. But a large and more affluent population means large increases in demand for many goods. Prices of haircuts, meals, bicycles and movies have not increased nearly as much as home prices. These other goods have remained affordable because as demand for these other products increased, few regulations prevented suppliers from bringing more goods to market. The market signals, created by the increase in demand, induced suppliers to provide more products. With more goods available, prices did not increase dramatically. The same market signals have not increased the quantity of housing supplied. The question is why?

Increasing prices usually provide all the information and incentives to encourage suppliers to provide more of a good. Housing prices in California have skyrocketed but have not been met with the usual increase in supply. The reason is simple: housing regulations have prevented builders from building enough new homes to meet demand. A myriad of regulations, prohibitions, and questionable liability laws discourages, and often prevents, new home production. Growth controls such as moratoria on new construction, preservation ordinances that do not open new land for development, environmental regulations that raise the cost and/or prohibit development in certain areas, legal and bureaucratic processes that can delay a development for years, and exclusionary zoning laws have all contributed to the high cost of housing in California. Facets of the California Environmental Quality Act,²⁶ passed in 1970, produced a number of problems. C.E.Q.A. gave power to local government to lengthen processing time indefinitely; what previously took one year now can take ten. Some of these regulations are passed at the state level and others come from municipalities. Regardless, the effect is the same: they prevent increases in the quantity of housing supplied and drive up the price of housing.

Finding that regulations and prohibitions on development cause high real estate prices in California is not a novel idea on our part. Economic theory and a number of studies on housing in California have, over the past 20 years, come to the same conclusion. Recent sophisticated econometric studies confirm these results. Research done by a Harvard University professor and a Wharton School professor on the effects of zoning regulation on home prices had similar findings. Edward Glaeser and Joseph Gyourko (2002) studied nation wide home prices and found that an “affordability crisis”

²⁶ Public Resources Code §§21000-21177

only occurred in particular geographic areas that had restrictive land use regulations. Higher land prices in California are not the main reason for higher housing prices. They find that scarce land does not produce high prices; instead, “Zoning and other land-use controls are more responsible for high prices where we see them.”²⁷ Entitled land has such high prices because permits to build are so scarce. Their econometric research concluded with a recommendation that:

If policy advocates are interested in reducing housing costs, they would do well to start with zoning reform. Building small numbers of subsidized housing units is likely to have a trivial impact on average housing prices, even if well-targeted toward deserving poor households. However, reducing the implied zoning tax on new construction could well have a massive impact on housing prices.²⁸

Other studies of Northern California have similar findings. A study by UC Berkeley economists Lawrence Katz and Kenneth Rosen on land use regulation’s effect on housing prices found that up until 1970 California housing had been in line with the national average of housing prices but by 1980 California housing prices more than doubled the national average. One of their major findings of the cause of the price increase is “a massive increase in the use of land-use and growth management techniques to slow and stop new housing production.”²⁹ In his study of housing costs throughout the United States, William Tucker (1990:5) concludes, “One thing is obvious: Stringent housing regulations have certainly not helped the San Francisco area solve its housing problems. They may even be creating the problems.”³⁰

Most zoning and growth control policies were well-intentioned, but they have produced the undesirable consequence of increasing housing prices for low-income households. Exclusionary zoning is one prime example. It limits lot sizes and types of units, and generally makes housing more expensive. But just because regulations pushed housing in one direction does not mean government should have more regulations to push housing in the other. Mandatory inclusionary zoning laws are not a good solution. Because interference in the market process leads to unintended consequences, we should be wary before interfering even more. The answer to high housing prices resulting from prior regulations is not increased regulations. Adding more regulations will only cause the cycle to continue and encourage further distortions in the future. An alternative solution is to encourage the issuance of building permits, open more land for development, and abolish exclusionary zoning laws. If government reduces and eliminates regulations that slow and prevent housing development, the housing market can respond to increased demand just like other industries in California.

²⁷ Edward Glaeser and Joseph Gyourko (2002) “Zoning’s Steep Price” *Regulation*, Volume 25 Number 3, Fall, p. 7.

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²⁹ Katz, Lawrence and Rosen, Kenneth (1980) *The Effects of Land-Use Controls on Housing Prices*. Berkeley, CA: Institute of Business and Economic Research.

³⁰ Tucker, William (1990) *Zoning, Rent Control, and Affordable Housing*, Washington, DC: Cato Institute.

8. Conclusion

We agree that housing prices in California are too high and should be more affordable. But an increase in “affordable” housing requirements will not improve the situation. Since the high price of homes is not the result of market failure but, instead from prior interventions in the housing market, we should deal with high prices by abolishing the policies that created them. The best way to allow supply to meet the unmet demand is to expedite the approval process for builders in Fort Ord. Imposing price controls and special burdens on builders will only lead to a lower number of homes being constructed.

Because the goal is to give residents more options, government should be encouraging the supply of housing, not discouraging it. Despite the good intentions, below-market housing quotas would have the unintended consequences of reducing the quantity of housing supplied and failing to lower prices. The extremely costly measure would provide few benefits. By reducing the residual value of the land by \$300 million, increased affordability regulations would prevent development altogether. Rather than helping, increasing “affordability” requirements would harm the housing sector, worsen the shortage and hurt high-income and low-income families alike. In conclusion, if we want to help the residents of Monterey County, which we all want to do, the last thing that should be done is to interfere with prices in the housing market.