



Bureau of Planning and Sustainability

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MEMO

DATE: November 4, 2016

TO: Planning and Sustainability Commission

FROM: Tyler Bump, Senior Economic Planner
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CC: Susan Anderson, BPS

SUBJECT: Inclusionary Housing Program

This memo is a response to major issues raised at the October 25, 2016 PSC public hearing and includes possible PSC actions for consideration at the November 8 PSC work session.

Summary of Findings

- An Inclusionary Housing (IH) program can be an important and effective tool to meet some of Portland's need for affordable housing. Policy 5.35 of the new Comprehensive Plan calls for the use of IH as a way to use the production of market rate housing to produce affordable housing.
- To be effective, an IH program cannot impact the financial feasibility of development to a level where new development does not take place. Both the production of affordable housing through IH and meeting city development goals depend on new development.
- The variables that can be adjusted to manage the IH program's impact on financial feasibility are the inclusion rate and the incentive package. The inclusion rates in the proposed zoning code are 20% of all residential units be affordable to households at 80% MFI ("20/80") or 10% of all units at 60% MFI ("10/60").
- The 10/60 program in the Central City with a full tax exemption is feasible and should move forward as proposed.



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- The 20/80 programs, both in and outside the Central City, and the 10/60 program outside the Central City will have a significant negative impact on development feasibility and adjustments to the inclusion rates are necessary.
- Potential inclusion rates that have less of an impact on feasibility are:

	80% AFI	60% AFI
Central City (greater than 5:1 FAR)	15%	10%
Central City (less than 5:1 FAR)	15%	8%
Outside the Central City	15%	8%

Introduction

One of the key principles is that the City of Portland needs an Inclusionary Housing (IH) program that links to the production of affordable housing to the production of market-rate housing (2035 Comp Plan Policy 5.35).

It is equally important to get the IH program right.

The cautionary tale in the testimony from developers is that the added costs of compliance with the proposed 20/80 and 10/60 IH requirements are so burdensome that it will discourage overall development. The combination of inclusion rate and the incentive packages need to be adjusted to offset most, but not all, of the added cost of providing the affordable housing. This increases confidence that the IH program will not significantly discourage the overall rate of development.

Otherwise, the decline in development activity will severely impair our city and regional development goals for a compact city that will further impair our ability to address housing affordability, reduce carbon emissions, and maintain a tight urban growth boundary.

At this point, the information and analysis currently available is not sufficient to make a confident recommendation. Therefore, the PSC has the challenge of making a decision that could go in four different directions:

1. Recommend the proposed Code and Program with conditions.
 - a. Rely on the Portland Housing Bureau (PHB) to find the resources to create an incentive package that will adequately offset the cost of compliance.
 - b. Recommend a framework of principles to affirm and the key questions to answer that would constitute an effective program that City Council needs to address prior to adoption.
2. Amend the proposed Code and Program based on the best available information.



- a. Given the uncertainty around the ability to create a more robust incentive package, especially outside the Central City, adjust inclusion rate or the applicable geography.
 - b. Recommend a framework of principles to affirm and the key questions to answer that would constitute an effective program that City Council needs to address prior to adoption.
3. Reject the proposed Code and Program
- a. Recommend a framework of principles to affirm and the key questions to answer that would constitute an effective program that City Council needs to address prior to adoption.
4. Take no action on the Proposed Code and Program
- a. Recommend a framework of principles to affirm and the key questions to answer that would constitute an effective program that City Council needs to address prior to adoption.

Inclusionary Housing Program Development Feasibility Analysis

As proposed there are two programs - a mandatory program at the 80% Median Family Income (MFI) level and a voluntary program at the 60% MFI level. As a matter of policy, the City of Portland wants to prioritize more units at the deeper affordability of the 60% MFI level. Therefore, this feasibility analysis focuses on inclusion rates at 60% MFI.

The way to prioritize the 60% MFI is to make the cost burden of IH program compliance less painful or even profitable at this level of affordability. The tools to do this are lowering the inclusion rate or offering more incentives.

The basic principle is that income from the development must exceed the cost of development sufficiently to provide adequate returns to the investors in the project. There are different ways to measure development feasibility in terms of value or profitability - residual land value, internal rate of return (IRR) and yield on costs (YoC).

The adequacy of returns from a project depends on many factors with the market for investment capital possibly being the most important for whether a project proceeds or not. Capital investors must evaluate the returns from Portland development against returns from development projects in other cities and other types of investment opportunities (stocks, bonds, T-bills). If returns from Portland investments are too low, capital investment likely will go to other opportunities that provide a greater return. If the IH program is too costly and reduces the return on investment too much, then the result will be fewer development projects in Portland.

Projects can absorb some level of increased costs and decreased returns and still be developed. At higher levels, the “gap” between costs and returns make it impossible to proceed with a project. The IH program addresses this feasibility gap by providing a suite of



financial incentives including density bonuses to offset the cost of providing the affordable units. As the inclusion rate increases, more incentives are needed to reduce the feasibility gap.

PHB contracted with David Rosen and Associates (DRA) to create a development feasibility model to use to design the IH program. That model measures feasibility using residual land value and internal rate of return. These are standard measures for how much a developer can afford to pay for land and make a competitive return on investment.

The DRA model found that, for some inclusion rates and geographies, the proposed IH program results in financially feasible development. In other circumstances, the study found that the proposed IH program results in residual land values are less than the market value. The IRR also is below market supportive yields.

The DRA model shows that the mandatory 20/80 program results in significant financial gaps for projects whether they are in or outside the Central City. The DRA model shows that the 10/60 program has sufficient incentives for feasible projects in the Central City but not those outside. The big difference in the incentive packages is that 10/60 offers a 10-year tax exemption on all units in the project, and 20/80 offers this only on the affordable units.

Oregon LOCUS, a coalition of real estate investors and developers, developed their own feasibility model based on Yield on Cost instead of residual land value. Their model shows similar results to the DRA model. The financial gap with the 20/80 program is large enough to significantly reduce the likelihood of development. Development under the 10/60 program in the Central City is more feasible.

Inclusion Rate and Incentive Package Linkage

There is a direct linkage between the inclusion rate (20 percent or 10 percent of units) and the incentive package that is available to offset the costs of providing the affordable units. The two policy options to reduce the feasibility gap are: (1) change the inclusion rate or (2) increase the incentives.

Increasing the incentive package costs more and comes with a good deal of uncertainty.

For instance, the total amount of 10-year property tax exemptions available each year for all city tax exemptions is set through an agreement between the jurisdictions that receive taxes - the City, Multnomah County and the school districts. The current cap is \$3 million per year. The PHB analysis indicates that this cap needs to be increased to more than \$4 million to cover the 10/60 program in the Central City. The cap increase would be much more if tax exemptions are used for all units in 10/60 program for development projects outside the Central City.

Direct financing - cash subsidies to developers to offset the cost of the affordable units - is another proposed incentive. Some of this funding is available from the Construction Excise Tax that the City of Portland adopted last summer. Given the analysis that is available at this time, it is unclear that there will be adequate funds available to reduce the feasibility gap to make an effective IH program outside the Central City.



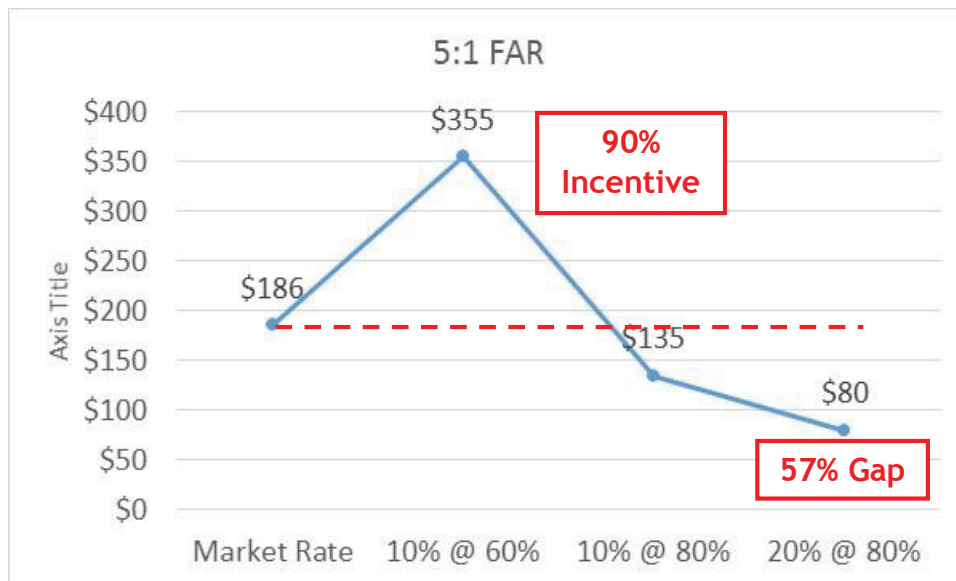
Given the uncertainty around both of these incentives and based on the information we have so far, the most predictable way to allow for adequate returns is to adjust the inclusion rates for either or both the 10/60 and 20/80 programs.

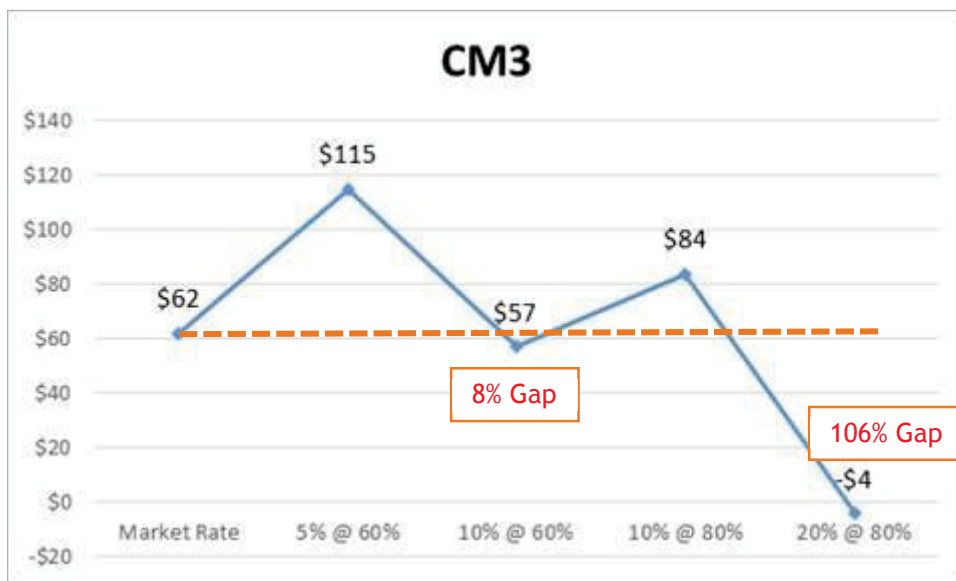
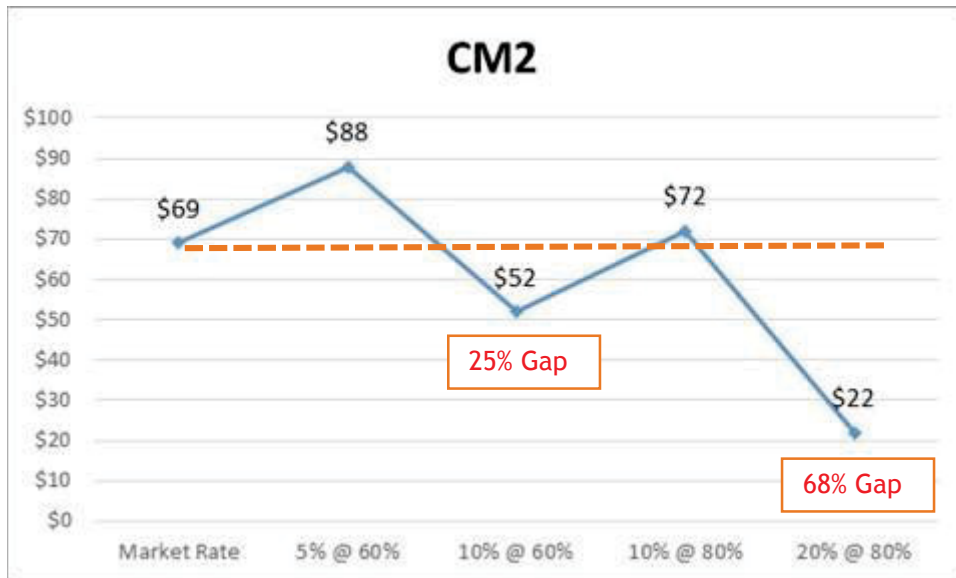
Inclusion Rate Sensitivity Tests

The DRA analysis only considered the 20/80 and 10/60 programs. BPS has done a preliminary estimate of how changes to a wider range of inclusion rates affects returns in terms of “residual land value” for different base zones. More detailed analysis needs to be done using the DRA model for both Residual Land Value and IRR to confirm these results.

As previously discussed, the 10/60 program in the Central City with a full tax exemption is feasible and BPS recommends moving forward with that program as proposed.

Based on these sensitivity tests, the 10/60 program outside the Central City can produce adequate returns by adjusting the inclusion rates, which reasonably reduces the feasibility gap to a level that could be absorbed by the development project. The smaller the feasibility gap, the less the potential for significantly reducing the overall rate of development in the city.





Determining what a reasonable feasibility gap might be is a difficult challenge that will take more time than what is afforded in this process. Therefore, one approach is to establish the IH program with a lower inclusion rate that can increase over time based on continued analysis or additional resources for incentives.

The table below shows the reduced inclusion rates that this preliminary analysis supports.



	80% MFI	60% MFI
Central City (greater than 5:1 FAR)	15%	10%
Central City (less than 5:1 FAR)	15%	8%
Outside the Central City	15%	8%

PSC Framework for Recommendations

While there is a need for more time and more analysis to make a more informed recommendation, the PSC has been directed by City Council to provide a recommendation on the IH program so that they can consider it in December 2016. There are a number of options that can go into the PSC's recommendations to City Council. There are two key components of the recommendation:

1. A framework of policy questions that City Council needs to answer to make an informed decision.
2. Title 33 amendments - forward, amend, reject or take no action on zoning code amendments.

Based on the PSC discussion at the October 25 public hearing and subsequent suggestions for a policy framework, the following policies are offered as a starting point for the PSC discussion:

Draft Framework Plan for Inclusionary Housing

The Planning and Sustainability Commission (PSC) has worked with BPS staff to craft a framework recommendation that represents the best proposal for City Council consideration given our time constraints.

Principles behind the PSC recommendations

1. The PSC fully supports implementing Inclusionary Housing for the desired to promote the production of affordable housing for a diversity of household types.
2. Inclusionary Housing is supported by the 2035 Comprehensive Plan
 - a. Policy 5.35
 - b. Establishing an IH program also is consistent with the Guiding Principles of the Comprehensive Plan - prosperity, health equity and resilience.
3. The PSC believes a successful IH program for Portland should at least meet the following objectives:



- a. Increase the supply of affordable housing by requiring mandatory program at 80% MFI and a voluntary program at 60% MFI for all new buildings of 20 or more units.
- b. The priority for incentives should be for the 60% MFI program.
- c. Support residential development production goals and distribution patterns consistent with the 2035 Comprehensive Plan and do not reduce the overall production of new housing units.
- d. Have sufficient and sustainable funding available to support IH incentives at expected housing production levels. This includes the amount of property tax abatements within caps, and SDC waivers.

The PSC is concerned that based on current available information, testimony received, and the City’s own financial projections, the proposed IH program cannot achieve all of these goals without amendments and further analysis.

It may be that the program warrants being phased in as a way to meet all objectives over time.

Recommendations and Next Steps

The PSC recommends taking more time to answer critical questions and to make sure the City get this important program right. The PSC recommends taking an approach that addresses the following steps and questions.

1. Estimate of total resources that will be available for IH incentives. Quantify available incentives that are fiscally and politically realistic (e.g. 3:1 FAR bonus; property tax abatements subject to cap; and SDC waivers for homes under 60% MFI).
 - a. What is a realistically achievable and sustainable incentive package?
 - b. Are the amounts available for proposed incentives sufficient for expected level of housing development?
 - c. Are increases in limits on proposed incentives possible financially or politically?
2. Determine the inclusion rate
 - a. What inclusion rate can reasonably be achieved given the current housing market and available public resources?



3. Evaluate other impacts.
 - a. What is the efficiency of IH versus using public resources for other affordable housing programs?
 - b. Are units produced with IH incentive packages lower cost on a per-unit basis than other means of using these financial resources to create similar affordable housing?
 - c. What are the trade-offs related to reprogramming public resources from current uses to IH?
4. Adjust IH program to work in different neighborhoods and densities. Adjust incentive bundles so the impact on residual land values is reasonably balanced across geographies and development densities throughout the city.
 - a. How can IH be designed to not increase residual land values in some areas and reduce them in others?
 - b. If the impacts are un-balanced, what would that mean for meeting the goals of the Comprehensive Plan?
5. Explore a voluntary system to get units in the current pipeline to incorporate permanently affordable units.
 - a. Could it be effective to offer limited property tax abatements to pipeline projects that include affordable housing?
 - b. Are there other approaches worth considering?
6. Consider phase-in of the IH regulations.

If the goal is to adopt an initial program quickly, be conservative in setting the program parameters like the inclusion rate and in-lieu fee. Set these at levels that reflect the questions and uncertainty about the current proposal and potential impacts.

A phase-in of the IH program provides an opportunity to evaluate and re-calibrate the program to be sure it is not restricting overall housing supply and thereby aggravating market-wide affordability problems.

Benchmarks should be established at the outset.

In the early years of the program, the fee in lieu should be set at modest levels to ensure it provides a realistic alternative, and the incentive package should be targeted to minimize a feasibility gap for new development.



For the Title 33 amendments, the PSC options are:

1. Recommend the proposed Code and Program (20/80 and 10/60).
2. Amend the proposed Code and Program based on the best available information.
 - a. Adjust the inclusion rate.
 - b. Adjust the geography - Central City and outside the Central City.
3. Reject the proposed Code and Program.
4. Take no action (abstain) on the Proposed Code and Program.

