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## Economics of Inclusionary Housing Policies: Effects on Housing Prices

*Question: If cities implement an inclusionary housing policy, will the price of market rate housing increase significantly?*

*Answer: No, the price of market rate housing will not increase significantly. The available evidence suggests the presence of an inclusionary housing policy may result in an increase in price of new market rate housing by no more than 3 percent—and likely will have no price effect at all.*

### Economic Theory

When adhering to an inclusionary housing requirement, developers experience an “opportunity-cost” for including below-market rate or affordable units within an otherwise market rate development. This opportunity cost is the difference between the market price the developer would have earned absent the policy and the lower price he actually receives from the affordable unit. As a result, under an inclusionary housing policy, the developer projects less revenue from the building.

In competitive housing markets, however, this cost increase does not directly lead to price increases. **That is, a single developer cannot “pass along” his increased costs to consumers.**

A developer faces competition from other developers building new housing and from the market for comparable existing housing. As a result, a single developer cannot increase his prices above the market equilibrium price. He would not be able to do this because customers will simply go elsewhere. Other developers, willing to accept smaller profits, will draw customers away from a developer who attempts to raise his price above the market equilibrium.

A developer who attempts to raise his prices above what the market will bear also faces competition from existing high-end homes and apartments. In fact, new housing makes up a very small share of the total housing in any community. Typically, fewer than 10 percent of the homes sold during a typical period are brand new. For example, of the 5.4 million homes sold in the United States in May of 2015, fewer than 500,000 were new homes.<sup>1</sup> As a result, if a developer raises his price on the units within his newly constructed building, house-hunters not only have options in other new buildings, they also have options in existing homes and apartments that are newly vacant.

It is a developer's job to make the maximum possible profit on any given development venture. If a developer could raise the price on their new market rate housing units, they would certainly do so—with or without the existence of an inclusionary housing requirement.

If costs increase for all developers (e.g., a tax or an increase in the price of land or construction costs) then prices may increase in certain markets where homebuyers and renters have few other choices. These special markets are marked by low vacancy rates, high levels of demand, and high desirability. They are often expensive, desirable urban areas. For instance, in unique neighborhoods in San Francisco or Manhattan, prospective upper income renters may be willing to “absorb” higher rents because they have a strong desire to live in those particular neighborhoods and no others.

In most cities in America, however, homebuyers and renters have many choices about where to live—including existing vacant homes and other nearby cities. In these places, developers who see their prices increase are not be able to pass along those costs to consumers.

As a result, an inclusionary housing policy can lead to higher prices only if consumers are willing to pay a premium to live in the location with the policy (Padilla 1995). In many cities, consumers are not willing to do so, and an inclusionary housing policy would lead to a small or zero effect on price.

## Economic Evidence

While there are no high-quality academic articles on the price effects of housing development impact fees, we can reasonably infer their effects from the evidence on inclusionary housing

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<sup>1</sup> Statistics on the sale of existing homes available from the National Association of Realtors online: <http://www.realtor.org/sites/default/files/reports/2015/embargoes/ehs-06-22/ehs-05-2015-overview-2015-06-22.pdf>. Statistics on the sales of new homes available from the U.S. Census Bureau online: <https://www.census.gov/construction/nrs/pdf/newressales.pdf>.

policies. There have been only a handful of economic studies of the price effects of inclusionary housing policies, and only three of these studies are methodologically reliable.<sup>2</sup>

These high-quality studies use a technique called “difference-in-differences,” which controls for spatial characteristics that do not vary over time (e.g., a city’s proximity to the ocean) and temporal characteristics that are uniform across geographies but vary by time (e.g., a statewide recession). As a result, these studies do not control for unobserved characteristics that vary by time and location (e.g., a recession hits one city harder than another). While these studies do use the best methodology available, this limitation can present a major problem if, for example, a city is more likely to implement an inclusionary housing policy when prices are rising relative to its peers. As a result, we can infer that **even the most carefully-designed studies likely overestimate the actual effect of inclusionary housing on market rate housing prices.**

In a study of California between 1988 and 2005, Bento, Lowe, Knaap, and Chakraborty (2009) found that housing prices in cities that adopted inclusionary housing policies increased about 2 to 3 percent faster than among cities that did not adopt such policies. They also found that inclusionary housing programs raised prices by about 5 percent for above-median priced houses, but for below-median priced houses, they lowered prices by about 0.8 percent.

One explanation for this finding is that in new buildings, which are subject to inclusionary housing requirements or housing development impact fees, developers will raise the price of their market rate units by about 5 percent to offset their costs. These price effects may pass on to the market for existing homes as individuals selling existing high-end housing will see that they can raise their prices by about 5 percent and still remain competitive. Another explanation for this finding is that supply of new housing may fall as some developers can no longer make their projects pencil in the presence of the new policy. When the supply of new housing falls and the number of people looking for new housing remains unchanged, the price of that new high-end housing would increase.

In one of the most recent studies of inclusionary housing, Schuetz et al. (2009) examine the impact of these policies on prices and production of market-rate housing in Boston and San Francisco. The primary difference between the Schuetz et al. (2009) paper and the earlier literature is that these authors use the natural log of years since the inclusionary policy was adopted to measure the presence of inclusionary housing policies. Basically, this model allows the authors to estimate an “exposure” effect of inclusionary policies—rather than calculating an

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<sup>2</sup> Other studies on this topic have provided anecdotal or qualitative evidence that linked inclusionary housing requirements with price increases in certain examples. However, due to their unreliable methodologies, these studies have failed to credibly establish causality in this relationship.

average effect over a whole period, they calculate an effect based on the number of years a policy has been in place.

In Boston, Schuetz et al. (2009) find that a 1 percent increase in the age of a program leads to a 1.4 percent increase in the prices of single family homes. In their simplest model, they find no effect of inclusionary housing policies on prices in San Francisco. . . For example, in numbers, supposing a single family home sells for about \$240,000 in the absence of an inclusionary policy, that unit would sell for less than \$5,000 more in the presence of an inclusionary policy that is at least five years old. An effect of this size, in practical terms, is dwarfed by larger market trends such as inflation and appreciation.

Finally, in a study for Cornerstone Partnership, now Grounded Solutions Network, Hollingshead (2015) examines changes in inclusionary housing policies that occurred in response to the 2009 decision by the California's Second District of Appeal in *Palmer/Sixth Street Properties LP v. City of Los Angeles*, when many jurisdictions in California eliminated or weakened their inclusionary housing policies.

The study fails to find evidence that developers lowered rental prices in cities that eliminated or weakened their rental inclusionary housing policies. In short, this means that developers likely do not lower the price of high-cost units in response to a city repealing or reducing the requirements of its inclusionary housing policy.

This report does, however, find a strongly statistically significant and positive effect of weakening an inclusionary housing policy on the price of low-cost units. It finds that weakening an inclusionary housing policy is associated with a 2 percent increase in median rental prices and a 3 percent increase in the price of low-cost units.

These findings suggest that while inclusionary housing policies may not result in significant price increases for high-end units, they do contribute to keeping prices lower for working class families.

## Summary

There is no doubt that cities enact inclusionary policies in response to eroding affordability (i.e., when prices are increasing). Unfortunately, even the high quality studies reviewed here cannot account for this fact. As a result of this bias, these studies likely overstate the effect of inclusionary housing policies on the price of new market rate housing.

However, the available evidence suggests inclusionary housing policies would increase the price of new market rate housing by no more than 3 percent. In many cases, especially in cities where homebuyers and renters have a great deal of choices in where to locate, these policies may not lead to any increase in price at all.

## Citations

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