

Inclusionary Housing



Minneapolis

Policy Recommendations and Economic Feasibility Analysis



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from the ground up

Introduction

Grounded Solutions Network was engaged to explore policy options and financial feasibility for a potential inclusionary housing policy for the City of Minneapolis. Under inclusionary housing policies, a certain percentage of units in new market-rate housing developments are sold or rented at below-market-rate prices to lower-income households.¹

Why inclusionary housing?

Our nation's legacy of economically and racially exclusionary policies has resulted in segregated cities and suburbs across the U.S. For example, federal redlining practices, which began in the 1930s, severely limited the ability of people of color to become homeowners. To this day, the impacts of inequality and segregation weigh heavily in neighborhoods in every corner of the country. Meanwhile, rising rents and

sales prices have dramatically outpaced wage growth. The U.S. Census tells us that about one-third of the population is now housing-cost burdened.

As part of Minneapolis's process of updating its Comprehensive Plan (Minneapolis 2040), the city council adopted a set of goals for Minneapolis's future. These goals include ensuring that all Minneapolis residents will be able to afford and access quality housing throughout the city. They also focus on reducing disparities—including housing disparities—among people of color and indigenous people compared with white people.

Development of new housing in many cities, including Minneapolis, tends to occur in amenity-rich areas with access to transportation choices, jobs, goods, services and recreation. The cost of this new housing is typically out of reach for Minneapolis residents with moderate or low incomes. At the same time, the Minneapolis

¹ Some inclusionary housing policies allow or require the payment of fees rather than the provision of affordable units on site.



2040 draft plan recognizes that as Minneapolis grows, neighborhoods will change, and an inclusive growth and development strategy is important to prevent involuntary displacement of existing low- and moderate-income residents in all Minneapolis neighborhoods. Inclusionary housing is one of the few policy tools available to create and retain mixed-income communities and address the impacts of historic racial and economic segregation.

Inclusionary housing also establishes expectations that new development has a role in bringing the community's values of inclusion and equity to fruition. One benefit of inclusionary housing is it offers a way to expand the supply of affordable housing beyond what could be achieved with public subsidy alone. The costs of providing affordable housing through an inclusionary

policy are generally passed back to landowners in the form of reduced land prices, or less of an increase in land prices than would otherwise occur. [see below]

Where some public subsidy is still needed, an inclusionary policy allows the city to right-size the amount of subsidy provided. There are several examples in Minneapolis where developers have provided some number of affordable units in their project in exchange for public subsidy such as tax-increment financing². However, these agreements were usually made on a case-by-case basis. An inclusionary housing policy formalizes expectations around the provision of affordable units in exchange for public subsidy. This makes the process more predictable and better aligns subsidy amounts with a project's financial feasibility.

Land Economics

While inclusionary housing programs directly impact the cost of development, they indirectly impact the price of developable land. When we increase the costs that developers face, we necessarily lower the amount that they are able to pay for land. Understanding how these requirements impact land values is vital for designing policies that appropriately allow communities to share in the benefits of new construction without stifling development.

The term "residual land value" refers to the idea that landowners capture whatever is left over after the other costs of development. When the cost of construction rises, it might hurt developer profits in the short term, but higher costs will then cause all developers to bid less for development sites. As land prices fall (or rise more slowly), developer profits tend to return to normal levels.

When developers are required by a city to provide affordable housing, they are likely to earn less than they would have if they had been able to sell or rent the affected units at market value. This forgone revenue represents the "opportunity cost" of complying with the affordable housing requirements. It is easy to calculate the opportunity cost for any given mix of affordable housing units, and if the affordable housing

requirements are predictable, the cost should translate roughly into corresponding reductions in land value over the longer term.

Most inclusionary housing programs don't simply impose costs; they also provide various incentives to help developers offset those costs, at least in part. These can be planning incentives, such as the right to build increased density or provide less parking, or financial incentives, such as a reduction in city fees or the provision of tax-increment financing.

But incentives frequently don't fully offset the cost of providing affordable housing. In these cases, there is a real net cost that pushes down land prices. If the net cost is small relative to land values, and if it is applied consistently and predictably, landowners have little choice but to accept reduced prices. But, if the net cost is too great, landowners may choose to not sell their properties, preventing development that would otherwise have happened.

For this reason, every city with an inclusionary housing program must pay careful attention to financial feasibility. There has been limited research on the economic impact of inclusionary housing, but so far, there is no evidence of

² Tax-increment financing, or TIF, dedicates the future increase in property tax revenues that occurs after a project is built (the 'increment' of tax revenue beyond the current base level) to help finance construction of the project.

Land Economics (continued)

a community's inclusionary requirements dramatically reducing the rate of homebuilding—suggesting that cities have generally taken this risk seriously and proceeded with appropriate caution.

Land values don't change overnight. Some communities have carefully phased in inclusionary requirements with the expectation that developers, when they can see changes coming, will be able to

negotiate appropriate concessions from landowners before they commit to projects that will be impacted by the new requirements. Similarly, some programs are likely to have a clearer, more predictable impact on land prices than others. More universal, widespread and stable rules may translate into land price reductions more directly than complex and changing requirements with many alternatives.

Scope of work

Should Minneapolis decide to adopt an inclusionary housing policy, the city must make the following choices:

- 1 Basic policy choices, including:** Will the same policy apply citywide or will it be modified for different neighborhoods? What percentage of units in a project should be affordable? What incentives will be offered to offset the costs of providing affordable units?
- 2 Detailed policy choices, including:** Will the policy apply only to residential projects above some threshold size? What will that threshold be? Will design standards be different for affordable units vs. market-rate units?
- 3 Choices regarding compliance alternatives, including:** Will the city allow developers other options to comply, such as paying an in-lieu fee or dedicating land? If so, how will compliance be measured (i.e. fee amounts or size of dedicated land)?
- 4 Choices regarding program implementation, including:** Will the program be staffed in-house or outsourced to another organization? How will affordable units be tracked and monitored over the long term?

Grounded Solutions Network's scope of work focused primarily on basic policy choices. We conducted policy research regarding national best practices, pros and cons of different policy choices, and case studies of three other cities' policies.

We also conducted limited financial feasibility analysis to inform the basic policy choices. While we were not

engaged to conduct a complete financial feasibility study, we developed project prototypes that allow us to compare the likely profitability of rental projects with no requirements to the profitability of those same projects if they provided a share of units at affordable rents, both with and without the provision of various incentives. This analysis will help local policymakers better anticipate the likely economic impact of including affordable housing units in typical development projects.

Summary of recommendations

Based on the results of the financial feasibility analysis, and on our experience with successful inclusionary housing programs across the country, Grounded Solutions Network recommends that the City of Minneapolis design an inclusionary housing policy that links the provision of affordable housing to a discretionary land use action, such as site plan approval, and provides developers two alternative for compliance:

- **Alternative 1:** Developers must provide 10 percent of rental units³ affordable to households earning up to 60 percent of area median income (AMI) with no public subsidy.
- **Alternative 2:** Developers must provide 20 percent of rental units affordable to households earning up to 50 percent of AMI. Tax-increment financing (TIF) will be available as needed to help the project achieve financial feasibility.

The remainder of this report provides the rationale for these recommendations.

³ Grounded Solutions Network's current scope of work did not include feasibility analysis for ownership projects; we recommend the city conduct such analysis if the inclusionary housing policy will apply to both rental and ownership projects.

Basic policy choices: purely voluntary or tied to discretionary land use approvals

National Trends: Adoption and Effectiveness

According to a 2017 report by Grounded Solutions Network, over 800 communities across the country have some form of inclusionary housing in place.⁴ Roughly three-quarters of jurisdictions with inclusionary programs surveyed had at least some mandatory element that required developers to comply.⁵ Many studies have shown that mandatory programs tend to produce more affordable units than voluntary programs, in which developers may choose to provide affordable housing in exchange for certain incentives.

For example, The Non-Profit Housing Association of Northern California found that voluntary programs in California produced significantly fewer homes than mandatory programs. Grounded Solutions Network's 2017 report supports that same conclusion: Jurisdictions with at least one mandatory program element produced roughly three times as many units per year and collected two orders of magnitude more fees per year than jurisdictions with purely voluntary programs.

Why are voluntary programs less effective in producing affordable units than mandatory programs? Many voluntary programs have been designed in such a way that the value provided by their incentives is frequently less than the cost of providing affordable housing. California jurisdictions, for example, frequently offer only modest density bonuses⁶ in exchange for expensive affordable homes. It is no surprise that many of these programs have not generated many affordable units.

In addition, with a program where affordability is required for most projects, incentives only need to get a development to break-even feasibility. With a voluntary

program, the incentives need to provide significant benefit beyond the project's profitability with no affordability included; this usually means a much larger subsidy, which jurisdictions are understandably reluctant to provide.

Finally, even in cases where the incentives are more valuable, affordable home requirements make projects more complex; many developers will choose to forgo the incentives even when it might be in their financial interest to accept them.

Recommendation for Minneapolis

Minnesota state law (Statute 462.358 Subdivision 11) specifically permits cities to condition discretionary land use approvals upon a developer's agreement to include affordable units. These discretionary land use approvals can include common actions, such as approval of a planned unit development or a site plan.

Grounded Solutions Network recommends that Minneapolis design a policy in which the provision of affordable housing is tied to a discretionary land use action, such as site plan approval, rather than use a purely voluntary or incentive-based approach.

There are several reasons—in addition to those already articulated in this report—why a voluntary program is particularly unlikely to work well in Minneapolis.

Many communities design a voluntary inclusionary housing program based on the use of planning incentives. By default, these cities maintain very restrictive base plans and zoning (i.e. they only allow limited density and require large amounts of parking),

⁴ *Inclusionary Housing in the United States: Prevalence, Impact, and Practices.* (Emily Thaden, Ph.D. and Ruoniu Wang, Ph.D., September 2017)

⁵ *Some programs had a mix of voluntary and mandatory elements. For example, in states where rent control is prohibited, some jurisdictions have a program which is mandatory for ownership projects but voluntary for rental projects.*

⁶ *Density bonuses are described in more detail in the Incentives section of this report.*

and they only allow developers to increase density and/or reduce parking in exchange for the provision of affordable housing.

For a variety of reasons—including creating a more walkable, people-oriented community design and reducing greenhouse gas emissions from transportation uses—Minneapolis has approached community development in a way that focuses on making it easier to build more homes and commercial space, particularly in areas downtown and near transit. This has included implementing best-practice planning strategies, such as allowing for denser development and reducing required parking in these areas.

Allowing denser development and reduced parking provides a significant financial benefit to development projects. Projects that take advantage of these benefits can see increased revenues from higher density and/or reduced costs from lower parking requirements. The increased revenues and/or cost savings can make it financially possible for projects to contribute more toward affordable housing than they would otherwise have been able to without those planning benefits in place.

However, since Minneapolis has already implemented these best-practice planning strategies, keeping the base zoning very restrictive is not a feasible option for the city. In fact, while the city offers three separate density bonus programs, including one for voluntarily providing affordable housing, the developers we interviewed generally agreed that they were frequently able to build at the optimal density without accessing the affordable housing density bonus.

In theory, it could be possible for the city to reduce allowed densities and/or increase parking requirements in certain areas in order to offer increased density and/or reduced parking as incentives in exchange for the provision of affordable housing. However, there are several practical downsides to this approach. First, it

would undermine the city's overall goals of creating livable and sustainable neighborhoods if developers chose to not take advantage of the incentives. Second, it would complicate the Comprehensive Plan update process, both policy-wise and politically (given that the community has already weighed in heavily to shape the new Comprehensive Plan). And third, actions like these that reduce the development capacity of sites would likely attract lawsuits claiming such actions are regulatory takings.⁷

The draft Comprehensive Plan update does propose some additional increases in allowed density and reductions in required parking beyond the current zoning code. However, these changes are unlikely to provide the level of financial benefit needed to make a voluntary inclusionary housing policy viable. This is particularly true in Minneapolis, where land costs are relatively low (compared to other high-cost areas like San Francisco or New York); density bonuses tend to be most financially beneficial in places with very high land costs.

While the proposed changes to the Comprehensive Plan are unlikely to make a voluntary policy viable, they do still improve the feasibility of new development, making more affordable units feasible than would have been without the new benefits. And adopting an inclusionary housing policy at the same time as new planning benefits allows developers to build in the cost of the affordable units from the start, making it more likely that land prices will adjust to accommodate the cost of affordability. The mandatory inclusionary zoning ordinance in Washington, D.C., and the mandatory housing affordability program in Seattle both work this way; these cities enacted affordability requirements simultaneously with an allowance for increased density (see case studies).

Another key policy choice for inclusionary housing programs is how long the regulated affordable units must remain affordable to low-income households before they can revert to market-rate prices.

⁷ A regulatory taking is a situation in which a government regulation limits the uses of private property to such a degree that the regulation effectively deprives the property owners of economically reasonable use or value of their property to such an extent that it deprives them of utility or value of that property.

Basic policy choices: Term of affordability

National Trends

While some early inclusionary programs had short (e.g. 10-15 year) terms of affordability, many jurisdictions quickly realized the challenges with short affordability terms.

For example, the widely copied program in Montgomery County, Maryland, created more than 12,000 affordable homes between 1973 and 2005. At the program's outset, the affordability term was only five years. In 1981, the affordability period was increased to 10 years. Because the affordability term was so short, by 2005 only 3,000 of those units were still affordable. In 2005, Montgomery County amended their program to require 30 years of affordability for new projects, and to reset this clock each time a regulated property was sold.

There has been an overwhelming trend for inclusionary housing programs to switch to very long-term affordability periods. Of the programs that reported an affordability term in Grounded Solutions Network's 2017 study, roughly 90 percent of them had an affordability term of 30 years or longer.

Recommendation for Minneapolis

The Minnesota state law that specifically permits cities to condition discretionary land use approvals upon a developer's agreement to include affordable units (Statute 462.358 Subdivision 11) limits rent and income limits to 20 years, except where public financing or subsidy requires longer terms. In addition, state law generally limits deed restrictions to 30 years (Statute 500.20 Subdivision 2a); this limit would apply even to projects that receive public financing or subsidy.

It is often less expensive to extend an affordability term for an existing affordable unit than to build a new affordable unit. As such, Minneapolis may want to consider providing public financing or subsidy (such as TIF) to some or most of the units created through an inclusionary housing policy in order to extend the affordability term from 20 to 30 years.

The following section on financial feasibility analysis includes a detailed discussion of the pros and cons of the use of public subsidy, including its impact on the allowed affordability term, and recommendations for use of public subsidy that balances multiple considerations.



Financial feasibility analysis

Why financial feasibility modeling?

In addition to the two basic policy choices described earlier in this report, there are several additional policy choices policymakers must make for an inclusionary housing policy. These include:

- ▶ The percentage of units within each new development that will be affordable;
- ▶ The affordability levels of those units (what household income levels the affordable units will serve);
- ▶ The incentives offered to developers to offset the cost of those affordable units; and
- ▶ Whether the policy will be the same citywide or vary by geographic area.

Financial feasibility modeling provides information to help policymakers with these policy choices.

Any inclusionary housing policy that is not purely voluntary involves some risk of overburdening development (with the additional cost of providing affordable homes) and reducing the pace of new building. In a voluntary program, if the incentives are not sufficient for project feasibility, developers will consequently not opt in to the program and proceed with their projects without building affordable units. In a program that is not purely voluntary, if the set-aside is too high and the incentives are not significant enough for projects to be feasible, developers' only choice is not to build new projects at all.

In addition, by their very nature, inclusionary housing policies only produce affordable housing when market-rate development projects are built.

For these reasons, every city with an inclusionary housing program that is not purely voluntary must pay careful attention to financial feasibility.

It is important to note that financial feasibility modeling is not a precise science. Ideally, financial feasibility modeling would allow policymakers to find the perfect combination of affordable housing percentage and incentives that maximizes the provision of affordable housing, while ensuring that the affordable housing set-aside does

not reduce the viability of market-rate development so much that it affects the rate of new housing construction. However, due to the large number of variables in economic modeling, and variation in financial details among different specific projects, it is not possible to precisely identify that ideal combination. Nonetheless, financial feasibility modeling can provide a range of affordable set-asides and incentives that will likely have only a small impact on the feasibility of new development.

Methodology – 2016 analysis

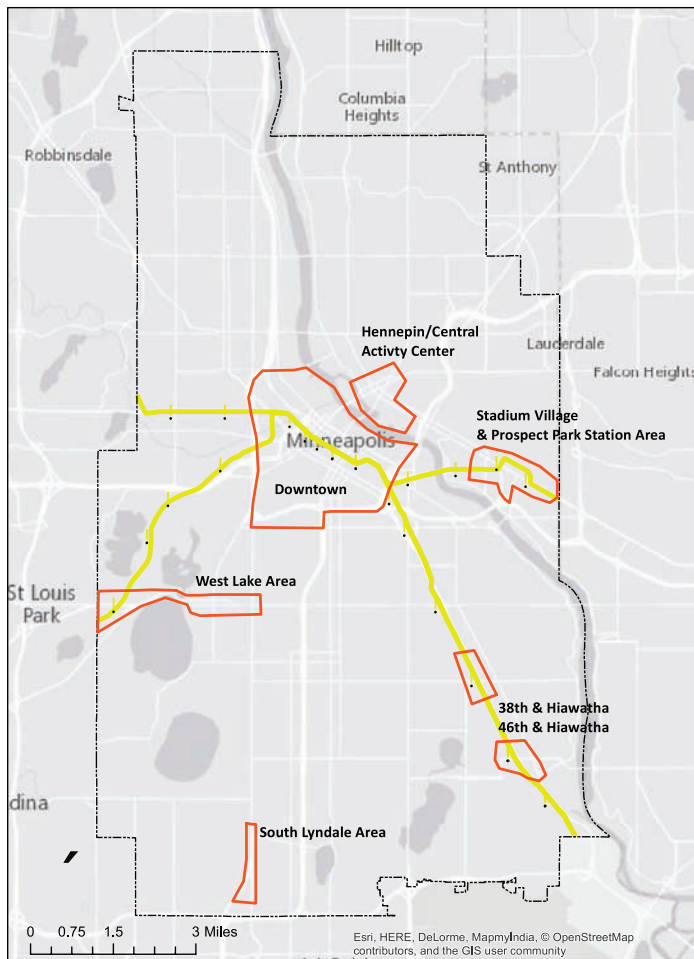
The financial feasibility analysis described in this report builds on feasibility analysis work that Grounded Solutions Network conducted for the City of Minneapolis in 2016. For that work, Grounded Solutions Network reviewed a series of recently published reports that included housing market analyses and conducted 17 interviews with local real estate developers and other key stakeholders. Based on the information gathered, we identified a set of six prototypical development templates, which reflected the most common development types being built in the Twin Cities at the time. These included wood-frame, mid-rise, and high-rise construction types for rental and ownership projects.

We then developed a financial model to evaluate the financial feasibility of each prototype. To do so, we collected detailed data about development costs and revenues from financial pro formas for recently completed multi-family real estate developments, market studies and appraisals, land value data from the assessor's office, rental and operating cost data from CoStar, and sales prices for townhomes and condominiums from Redfin and Zillow.

After soliciting feedback on our prototype models from local development industry stakeholders and adjusting the models based on that feedback, we then adjusted these general prototypes to reflect economic differences among neighborhoods, looking at seven different neighborhood study areas that reflected different housing markets. These areas were selected because they had either experienced significant growth in recent years or because of their perceived market strength and potential for housing growth.



Figure 1: Map of Neighborhood study areas



For each viable combination of development prototype and neighborhood study area, we asked two questions. First, was this development prototype in this neighborhood financially feasible to build even without an affordable housing set-aside? And second, would this development prototype in this neighborhood be financially feasible to build with a 15 percent affordable housing set-aside?

Even without including any affordable housing, only roughly half of the combinations we tested were clearly financially feasible to build—specifically, most prototypes in the Downtown, Hennepin and West Lake study areas, and two prototypes in the Stadium study area. And when we added a 15 percent affordable housing set-aside, the number of combinations that were clearly feasible dropped to roughly one-fifth of the combinations we tested—specifically, a subset of prototypes in the Downtown and West Lake areas.

Our 2016 study, however, did not model the impact of including incentives. We concluded our report by

recommending further research to evaluate ways for the city to provide incentives that would partially offset the cost of compliance and make affordable housing requirements feasible in a greater range of projects.

Incentives

Both voluntary and mandatory programs tend to rely on incentives to make affordable housing financially feasible. If the goal of an inclusionary requirement is to enable developers to earn normal profits while capturing some share of excess profits for public benefit, any incentive a city can offer to make development more profitable enables the imposition of a higher inclusionary requirement than would otherwise be feasible.

However, incentives generally come at a real cost to the public sector. If inclusionary housing requirements are modest enough to be absorbed by land prices, then any incentives merely move the cost from landowners back onto the public. Incentives such as tax abatements, tax-increment financing and fee waivers reduce revenues available to jurisdictions. Even planning incentives such as density bonuses, which appear free, result in increased infrastructure and other public costs. Communities must carefully weigh the costs and benefits of each incentive and evaluate them relative to the cost of providing a specific percentage of affordable housing.



Incentives tend to take one of two forms:

planning incentives or financial incentives. Planning incentives address feasibility by increasing project density or lowering costs through mechanisms like reducing parking requirements. Financial incentives provide direct savings or public subsidies to offset all or a portion of the cost of providing affordable units. The most common incentives are listed below.

Planning incentives

- ▶ **Density bonus.** A density bonus provides an increase in allowed dwelling units per acre, floor area ratio (FAR) or height—which generally means that more housing units can be built on any given site. Typically, programs allow increases of between 10 percent and 20 percent over baseline permitted density in exchange for the provision of affordable housing.
- ▶ **Parking reduction.** Some programs allow projects with affordable units to build fewer parking spaces than would otherwise be required under local zoning rules. This incentive can result in significant construction cost savings particularly for projects that would typically build parking structures. Reductions of 10 percent to 20 percent in required parking are common.
- ▶ **Expedited processing.** Expedited processing moves projects with an affordable component to the front of the line in zoning, planning and building permit processing. Ideally, this can shave months off the entitlement process. Faster processing reduces risk and financing costs, and it allows developers to bring projects to market faster. This is an easy incentive for cities to promise, but in practice it may not always translate into meaningful time savings for developers. Given limited staff resources, there is a limit to how quickly permits can realistically be processed.

Financial incentives

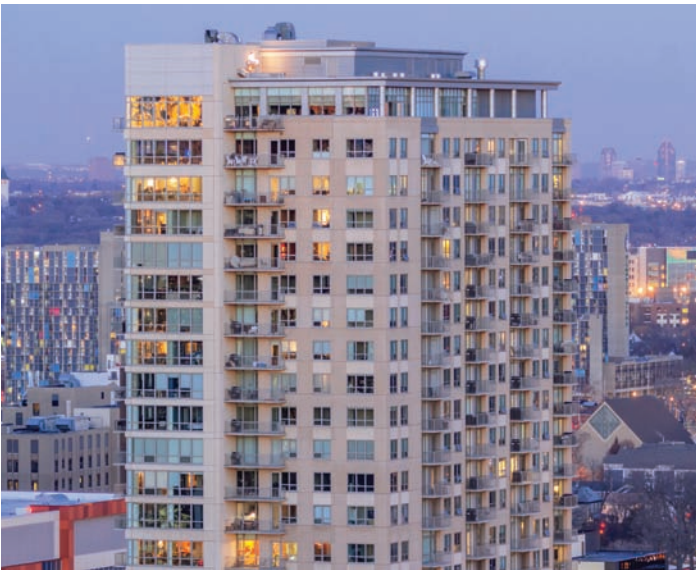
- ▶ **Fee waivers.** Many communities offer partial or full waivers of planning fees, permitting fees, or impact fees to projects that include affordable units.
- ▶ **Tax abatement.** Property taxes are one of the more significant annual expenses associated with housing. Some communities offer a partial abatement or complete waiver of property taxes to owners of projects with affordable housing.
- ▶ **Tax-increment financing (TIF).** TIF dedicates the future increase in property tax revenues that occurs after a project is built (the 'increment' of tax revenue beyond the current base level) to help finance construction of the project and/or subsidize the affordable rents.

According to Grounded Solutions Network’s 2017 study, 75 percent of inclusionary housing programs offer one or more incentives. Of those programs offering incentives, the most common incentives offered were density bonuses (78 percent), other zoning variances such as parking reductions (44 percent), or fee reductions or waivers (37 percent). In contrast, only a small portion of programs (11 percent) incentivized developers to participate in the inclusionary housing program through direct public subsidy and/or tax-increment financing (TIF) or other tax abatement approaches.

As described in detail earlier in this report, Minneapolis has already implemented many best-practice planning strategies, such as allowing for denser development and reducing required parking in key areas. These benefits can provide a significant economic benefit to developers, making it financially possible for projects to contribute more toward affordable housing than would otherwise have been able to without those planning benefits in place.

However, since the city has already implemented these best-practice planning strategies, they are no longer able to be used as incentives in an inclusionary housing policy in the traditional manner. Therefore, we focused our modeling primarily on financial incentives. Our analysis focused on the use of TIF, but this can be a proxy for any type of substantial city financial support.

One added benefit of using a financial incentive structured like TIF is that it can be provided on an annual basis to support the affordable rents, essentially serving as a tenant subsidy.



Methodology – 2018 analysis

For our current economic analysis, we added a third key question: Would this development prototype in this neighborhood be financially feasible to build with affordable housing and incentives?

We updated our 2016 prototypes for a subset of the development types and neighborhood areas with new data, using a similar process to the one we used in 2016 to collect and refine that data. Because the great majority of recent multi-family housing projects in Minneapolis were rental projects, we focused initially on updating the rental prototypes. We analyzed the following three development types:

- 1 Wood-frame Rental
- 2 Mid-rise Rental
- 3 High-rise Rental

Table 1: Development Types

	Wood-frame Rental	Mid-rise Rental	High-rise Rental
Number of units	100	150	200
Building height	5-6 stories	12+ stories	20+ stories
Construction type	Wood construction over concrete podium parking	Concrete construction	Steel construction

These development types are meant to illustrate some, but not all, of the types of development currently being built in the Minneapolis market. Since this list of development types does not include any homeownership products, additional feasibility analysis would be needed to establish feasible combinations of affordable set-asides and incentives for homeownership projects. In addition, there are likely smaller-scale developments (e.g. 10-unit projects or fourplexes) that would have significantly different economics than the smallest-scale project we modeled (the wood-frame rental prototype); this analysis does not apply to those projects.

We built development prototypes⁸ in the following four housing market neighborhood types for each development type that made sense in each neighborhood⁹:

- 1 Downtown
- 2 Strong markets: Strong market areas outside of downtown where current zoning allows dense urban development (examples: West Lake, Hennepin)
- 3 Emerging markets: Mixed-market areas where the draft Minneapolis 2040 plan provides for significant increases in density (example: the blue line transit station areas)
- 4 Soft markets: Softer market locations where multi-family residential is allowed but not currently being built (example: South Lyndale)

Due to the wide variety in the economics between different projects and different locations, the data we collected on key inputs from different sources sometimes differed in important ways. The prototype models that we produced realistically reflect actual projects being built in the market at the time, but they are not necessarily average. Many real projects will differ from these prototypes in terms of cost, rents, unit configuration and many other

factors. The prototypes allowed us to evaluate the impact of potential affordable housing set-asides and incentives on several realistic projects, but they are not intended to represent the impact on all actual or potential projects.

It's important to note that this feasibility modeling is a point-in-time analysis. The numbers used in this analysis—things like construction costs, land costs and housing prices—change over time. A change in any one of those numbers—or any of a whole host of other variables used in the feasibility analysis—can change the answers to any of those three questions. For example, if rents go up faster than development costs, a higher affordability percentage could be supported. Conversely, if construction costs rise faster than rents, the amount of affordable housing that a development can feasibly provide will decrease. For this reason, it's important to build in a healthy margin of error when establishing the parameters for an inclusionary housing policy.

One particular cause for concern is the rate at which construction costs have apparently been rising. Our feasibility analysis reflects the current situation, but it does not attempt to anticipate what will happen next in the market. Many of the developers that we spoke with expressed concern that rising hard costs would

Table 2: Development Prototypes: Rents and Land Costs

	Downtown	Strong markets	Emerging markets	Soft markets
Wood-frame				
Average residential rent per sq.ft.	\$2.33	\$2.27	\$2.00	\$1.91
Land cost per unit	\$27,500	\$22,500	\$10,000	\$8,000
Mid-rise				
Average residential rent per sq.ft.	\$2.37	\$2.32	\$2.19	\$1.91
Land cost per unit	\$25,000	\$25,000	\$10,000	\$8,000
High-rise				
Average residential rent per sq.ft.	\$2.42	\$2.40	\$2.08	N/A
Land cost per unit	\$35,000	\$27,500	\$10,000	N/A

⁸ More numeric details for each of the prototype models can be found in the appendix to this report.

⁹ We did not model the high-rise development type in the soft market neighborhood type.

soon make multi-family rental projects infeasible. The cost of construction per unit has risen much faster than inflation since we studied the Minneapolis market in 2016. Development has continued over this period only because rents have also been increasing rapidly. In particular, the rents being charged in newly constructed rental properties have risen as builders have focused on higher-end buildings with luxury amenities.

While it is not possible to predict when the market will change, this is not a trend that is likely to continue indefinitely. There will come a point where the cost of construction rises beyond what even luxury tenants are willing or able to pay for an apartment in Minneapolis. After that point, it is likely that the city will face a significant reduction in the rate of new residential construction until either costs are reduced or rents increase further. We don't see this as a reason not to adopt an inclusionary housing policy—established policies have to weather the ups and downs of the market cycle—but it is a reason to proceed with caution at this moment.

Evaluating feasibility

The real estate development industry uses a number of different metrics to gauge the financial feasibility of potential projects. No one measure is appropriate for all purposes. The local developers we engaged consistently suggested that yield on cost would be the most appropriate measure of profitability for rental projects. Yield on cost is calculated by dividing the development's projected annual net operating income (NOI) by its projected total development cost (TDC). The resulting number provides a rough measure of whether the future cash flow from a project will be high enough to justify the expense of development.

Available data on recent rental projects in Minneapolis indicates that developments with a projected yield on cost of at least 5.9 percent would generally be feasible to build, and those with a yield below 5.7 percent would generally not be feasible. Projects with a projected yield between 5.7 percent and 5.9 percent are more marginal, meaning that some projects within this range would likely move forward, whereas other projects within that range would likely not be built.

Results

For each prototype, we asked three questions:

- 1 Is this development prototype in this neighborhood financially feasible to build even without affordable housing?
- 2 Would this development prototype in this neighborhood be financially feasible to build with affordable housing but no incentives?
- 3 Would this development prototype in this neighborhood be financially feasible to build with affordable housing and incentives?

Question 1: Is this development prototype in this neighborhood financially feasible to build even without affordable housing?

Table 3: Results, no affordable housing

	Down-town	Strong market	Emerging market	Soft market
Wood-frame Rental	6.29%	6.26%	5.84%	5.08%
Mid-rise Rental	5.74%	5.61%	5.54%	4.80%
High-rise Rental	6.28%	6.20%	5.79%	N/A

With no affordable housing, the wood-frame rental and high-rise rental prototypes are currently feasible in downtown and other strong market areas. Mid-rise product is currently less feasible, so developers are likely to choose to build other, feasible development types. In emerging markets, development feasibility is more marginal; projects may or may not pencil out, even without any affordable housing. Inclusionary housing in those areas has the potential to make otherwise-feasible projects infeasible. In soft market areas, the market-rate housing prototypes we analyzed are not currently feasible. This means that an inclusionary housing policy would not make currently feasible projects in those areas infeasible.

The remaining discussion focuses primarily on the wood-frame rental and high-rise prototypes in the downtown, strong and emerging markets. The feasibility of these prototypes (unlike that of the other prototypes) might be impacted by a potential inclusionary housing policy in the short term.

Question 2: Would this development prototype in this neighborhood be financially feasible to build with affordable housing but no incentives?

To answer this question, we looked at several different affordable housing set-asides: 15 percent of units, 10 percent of units and 5 percent of units. In all cases, we targeted the affordable units to households making up to 60 percent of area median income (AMI).

Table 4: Results, 15% of units affordable at 60% AMI

	Down-town	Strong market	Emerging market	Soft market
Wood-frame Rental	5.96%	5.95%	5.62%	4.99%
Mid-rise Rental	5.34%	5.22%	5.20%	4.57%
High-rise Rental	5.94%	5.86%	5.54%	N/A

With a 15 percent affordable housing set-aside, the feasible prototypes in downtown and strong-market areas generally remain feasible (though with yields on cost that are just barely above our feasibility threshold), except the high-rise product in strong markets outside downtown, which tips over into marginal. Not surprisingly, emerging market developments become less feasible with this level of set-aside.

Table 5: Results, 10% of units affordable at 60% AMI

	Down-town	Strong market	Emerging market	Soft market
Wood-frame Rental	6.07%	6.06%	5.70%	5.02%
Mid-rise Rental	5.48%	5.36%	5.32%	4.65%
High-rise Rental	6.06%	5.97%	5.63%	N/A

If we reduce the affordable housing set-aside to 10 percent, the wood-frame and high-rise prototypes in the downtown and strong-market areas become feasible, the wood-frame rental prototype in emerging market areas just barely hits our threshold for marginal, and the high-rise product is still infeasible in emerging market areas.

Table 6: Results, 5% of units affordable at 60% AMI

	Down-town	Strong market	Emerging market	Soft market
Wood-frame Rental	6.17%	6.15%	5.76%	5.05%
Mid-rise Rental	5.61%	5.48%	5.43%	4.73%
High-rise Rental	6.16%	6.08%	5.71%	N/A

When we reduce the affordable housing set-aside to 5 percent in emerging-market areas, both the wood-frame and high-rise product types achieve marginal feasibility (similar to the feasibility results without any affordable housing).

Question 3: Would this development prototype in this neighborhood be financially feasible to build with affordable housing and incentives?

As described previously, we focused our analysis of incentives on the provision of tax-increment financing (TIF). Minnesota state law requires that in order to use a housing TIF district, 20 percent of the housing units must be affordable to households making up to 50 percent of AMI.¹⁰

Table 7: Results, 20% of units affordable at 50% AMI, maximum TIF

	Down-town	Strong market	Emerging market	Soft market
Wood-frame Rental	6.82%	6.81%	6.39%	5.58%
Mid-rise Rental	5.94%	5.80%	5.77%	4.99%
High-rise Rental	6.82%	6.70%	6.30%	N/A

Modeling use of the maximum TIF¹¹ to support this affordable housing set-aside, the emerging market wood-frame and high-rise prototypes now meet our feasibility threshold.

However, projects that use TIF need to meet a set of public requirements, including the small underutilized business program and prevailing wage requirements, which increase construction costs and financing fees.

It is likely that projects using TIF would face higher construction costs than what has been projected in our base prototypes. However, there is no clear standard for how much these requirements would increase costs. Some of the recent projects that we reviewed used TIF while others did not. But because of the wide variation among projects and the rapid changes in the overall cost of construction, it was not possible for us to isolate the impact of prevailing wage or other requirements. Purely for illustration purposes, we evaluated a scenario where we increased construction costs by 10 percent to reflect prevailing wage and other additional costs. For some projects, it is likely that the cost impact of TIF would be greater, while for others it may be less.

Table 8: Results, 20% of units affordable at 50% AMI, maximum TIF, construction cost increase of 10%

	Down-town	Strong market	Emerging market	Soft market
Wood-frame Rental	6.26%	6.24%	5.84%	5.11%
Mid-rise Rental	5.44%	5.31%	5.26%	4.55%
High-rise Rental	6.22%	6.11%	5.72%	N/A

Using those assumptions, the emerging market wood-frame and high-rise prototypes again fall into the marginal category (similar to the feasibility results without any affordable housing), even using TIF as an incentive.

¹⁰ Redevelopment TIF districts would have different affordability requirements, but would not be available for use in all parts of the city.

¹¹ If the City were to provide TIF as a potential incentive, it would not need to provide the maximum TIF for every project and could instead right-size the amount of TIF provided to what is necessary for the project to be financially feasible. For simplicity, we modeled the use of maximum TIF.

Basic policy choices: Variation by housing market

The results of the feasibility analysis for Minneapolis point to significant differences in housing market dynamics in different areas of the city. Specifically, downtown and other strong market areas have higher housing prices and can support a higher affordable housing set-aside (and/or need fewer incentives), while the emerging markets and soft-market areas have lower housing prices and can support less of an affordable housing set-aside (and/or need more incentives).

One way to address this challenge is to vary the program geographically. Most cities do not adjust their inclusionary requirements at a neighborhood level. Of the inclusionary housing programs featured in Grounded Solutions Network's 2017 report, 71 percent of programs apply to the entire jurisdiction.

However, some communities do choose to vary requirements to address differences in housing markets. Seven percent of programs featured in Grounded Solutions Network's report apply to the entire jurisdiction, but they include program requirements that vary by geography. Chicago's program fits into this category (see case study). The remaining 22 percent of programs only cover certain zones, neighborhoods or districts within the jurisdiction. Programs in Washington, D.C., and Seattle fit into this category (see case studies).

The main benefit to creating a geographically targeted policy is that it can more accurately tailor the affordable housing set-aside and incentives offered to different markets, maximizing affordable housing production in each neighborhood, while minimizing unnecessary public subsidy.

One significant challenge with creating a geographically targeted policy is that the process of drawing boundaries for the different areas can be time-consuming and politically fraught. All three of the programs featured in the case studies in this report used existing boundaries (e.g. zoning districts or neighborhoods) in their inclusionary housing policies. There are no obvious existing boundaries in Minneapolis that clearly align with the different housing market areas.

In addition, while using existing boundaries can make the process somewhat easier, deciding which affordable housing set-aside and which incentives apply to each area

can be challenging. And because market conditions change over time, boundaries may need to shift every few years to keep up with changing conditions. Geographically targeted programs may also be more complex to administer, and they still may fail to capture all the important fine-grained differences among projects.

There are some options that address variations in housing market strength within a city without drawing geographic boundaries. Burlington, Vermont, has an inclusionary program in which the affordable housing set-aside varies between 15 percent and 25 percent of the units, depending on the average price of the market-rate homes in the project. This is not a commonly used approach. To obtain financing to build a project, developers must show a housing price at build-out that makes the project financially feasible. This may or may not be the price that the developer charges once the project is built. Once the project is built, if the housing market supports higher prices or rents than those that were necessary to make the project pencil out, the project may end up providing fewer inclusionary units than it should. Conversely, if the housing market changes and rents go down, the project may end up providing more inclusionary units than it should. In addition, this option may be time-consuming to administer since the set-aside is calculated on a project-by-project basis.

Another way to address variations in housing market strength within a city is to have a citywide program that provides multiple options for compliance, some of which might make more sense than others in certain housing markets. For example, in Evanston, Illinois, and Chicago (see case study), developers can set aside 10 percent of units as affordable with no public subsidy or set aside 20 percent of units as affordable in exchange for public subsidy. In softer market neighborhoods where a 10 percent set-aside without subsidy would not be feasible, developers can choose the 20 percent set-aside with subsidy. In stronger market areas, a 10 percent set-aside with no subsidy may be more profitable than a 20 percent set-aside with subsidy. The biggest challenge with this approach is determining how much subsidy to offer each project. Projects in softer market areas may need a large subsidy, while projects in stronger market areas will likely need less.



Policy options for Minneapolis

Based on the results of the financial feasibility analysis, and on our experience with successful inclusionary housing programs across the country, Grounded Solutions Network created three feasible policy options for a potential inclusionary housing policy in Minneapolis.¹² By “feasible,” we mean that most projects that are feasible without any affordable housing would remain feasible under the proposed policy option. As described earlier in this report, there are certain areas and prototypes (namely soft-market areas and mid-rise prototypes) that are not currently feasible even without any affordable housing; those remain infeasible under the proposed policy options.

Policy Option 1 would be a citywide program in which developers have two alternatives for how to comply:

- ▶ Alternative 1: Provide 10 percent of units affordable to households earning up to 60 percent of AMI without subsidy; or
- ▶ Alternative 2: Provide 20 percent of units affordable to households earning up to 50 percent of AMI with subsidy available on an as-needed basis.

Policy Option 2 would be a geographically targeted program that would not use subsidy at all. Projects in downtown and strong market areas would provide up to 15 percent of units affordable to households earning up to 60 percent of AMI. Projects elsewhere in the city would provide 5 percent of units affordable to households earning up to 60 percent of AMI.

Policy Option 3 would be a hybrid of Option 1 and Option 2. Projects in downtown and strong market areas would provide up to 15 percent of units affordable to households earning up to 60 percent of AMI without subsidy. Projects elsewhere in the city would provide 20 percent of units affordable to households earning up to 50 percent of AMI with subsidy available on an as-needed basis.

Pros and cons of policy options

Policy Option 1: Choice of 10 percent of units at 60 percent AMI without subsidy; or 20 percent of units at 50 percent AMI with subsidy

One benefit of Policy Option 1 is that it addresses variation in housing market strength without the multiple downsides of drawing geographic boundaries. The likely impact of Policy Option 1 is that developers of projects in emerging-market areas will tend to use alternative 2 (20 percent at 50 percent AMI with subsidy) for the near future, since alternative 1 (10 percent at 60 percent AMI with no subsidy) is not currently financially feasible. In downtown and other strong market areas, where development is profitable without subsidy, developers may opt for alternative 1 to avoid the constraints, increased financial complexity, and delays that can come with public subsidy, particularly TIF. This achieves our goal of getting different outcomes in areas with different housing markets.

If alternative 1 were changed to 15 percent at 60 percent AMI with no subsidy, alternative 2 would become the more appealing choice for many more projects in downtown and strong markets. The feasibility results with a 15 percent set-aside are much closer to the threshold between feasible and marginal, meaning more projects would need public assistance to be viable. This would increase the administrative burden and potential project delays associated with the use of TIF. It would also be a large drain on public resources that could potentially be used more effectively for other purposes (including other affordable housing programs).

Another benefit of Policy Option 1 is that it provides a choice for how to comply, making it more likely that the inclusionary housing policy will work for projects with different characteristics. For example, if a project is located in a stronger market areas, but it has economics that are more like an emerging-market project, the developer can choose alternative 2, rather than simply not building the project at all. This option also provides

¹² All of these policy options apply only to rental projects; we recommend the City conduct further analysis to shape policy options for ownership projects.

alternatives for developers with different financial capacity and varying experience levels with public finance requirements.

Another advantage of this approach is that it may provide more flexibility as market conditions change. When market conditions make it difficult to build, projects require more subsidy and are more likely to choose alternative 2. And when the market is strong, projects require less subsidy and are more likely to choose alternative 1. While this alone won't eliminate the market cycles that appear to drive the real estate industry everywhere, Policy Option 1 could help stabilize building conditions during periods of market booms and busts, which could result in the building of more housing, including affordable housing.

In addition, projects that opt for alternative 2 could have an affordability term of up to 30 years (the maximum length of a deed restriction for projects that receive public subsidy) rather than 20 years (the maximum affordability term permitted without public subsidy). And the overall production of affordable housing is fairly high, with every project providing a set-aside of 10 percent or 20 percent of affordable units.

The downsides of Policy Option 1 are related to the projects that opt for alternative 2. Use of public subsidy can be a heavy administrative burden, both to determine the needed subsidy amount on a project-by-project basis, and in the case of TIF, to establish the TIF district. The process of establishing a TIF district can also take longer than the normal permitting process, potentially delaying projects that choose this option by several months. However, there may be opportunities to streamline these processes, reducing the extent of these disadvantages.

Policy Option 2: up to 15 percent of units at 60 percent AMI in strong markets; 5 percent of units at 60 percent AMI elsewhere; no subsidy

If the city selects Policy Option 1 or Policy Option 2, it will need to determine the required percentage of affordable units in strong market areas. While our analysis suggests that many downtown and strong market projects could support up to 15 percent affordable units (at 60 percent of AMI) today, the closer we get to this upper limit, the greater the number of otherwise feasible projects that might not be built because of the housing requirements. It may be wise to adopt a lower requirement to account for uncertainty due to changing market conditions.

One benefit of Policy Option 2 is that a public subsidy is not needed. And without the use of subsidy, administration of the program is simpler and less costly, and projects will use the normal permitting process rather than risk potential delays from the creation of a TIF district.

One downside of Policy Option 2 is that it requires a time-consuming and politically fraught process to draw the geographic boundaries that divide downtown and strong market areas from the rest of the city (and brings the other downsides of using geographic boundaries described above). And while this option has a high production of affordable units in downtown and strong market areas, fewer affordable units would be created elsewhere in the city under this option than under Policy Option 1. Finally, without the use of subsidy, the term of affordability would be limited to only 20 years for every project.

Policy Option 3: up to 15 percent of units at 60 percent AMI in strong markets, no subsidy; 20 percent of units at 50 percent AMI elsewhere with subsidy

Policy Option 3 is a hybrid of Policy Option 1 and Policy Option 2, facing many of the same benefits and drawbacks as those options.

As with Policy Option 2, the production of affordable units in downtown and strong market areas is high without relying on public subsidy. And as with Policy Option 1, the production of affordable units elsewhere in the city is also high due to use of public subsidy.

Like Policy Option 1, Policy Option 3 offers a longer affordability term for projects that receive subsidy, but that benefit will apply to fewer projects since subsidy will not be available to projects in downtown or strong market areas. Conversely, Policy Option 3 also experiences the same TIF-related downsides (administrative burden and potential project delays) as Policy Option 1, but those downsides will affect fewer projects.

The biggest drawback of Policy Option 3 is that, like Policy Option 2, it comes with all the downsides of using geographic boundaries described previously. In addition, there may be some projects in strong market areas that would have relatively lower rents and would likely not be built without the opportunity to use subsidy, which would be available with Policy Option 1.

The pros and cons of the three options are summarized in Table 9.

Table 9: Relative benefits of the three policy options

	Policy Option 1	Policy Option 2	Policy Option 3
Need to draw boundaries	Best	Worst	Worst
Affordability term	Mixed	Worst	Mixed
Subsidy-related administrative burden	Mixed	Best	Mixed
Potential TIF-related project delays	Mixed	Best	Mixed
Affordable housing production	Mixed	Mixed	Best
Minimize city subsidy	Mixed	Best	Mixed

Recommendation for Minneapolis

Grounded Solutions Network recommends that the City of Minneapolis design an inclusionary housing policy based on Policy Option 1. This option successfully

balances a variety of policy considerations—from affordable housing production and retention, to use of public subsidy to administrative burden—while avoiding the initial and ongoing complications of a geographically varied policy.



Case Study — Washington, D.C.

Washington, D.C., enacted a mandatory inclusionary zoning (IZ) program in 2006 and made it effective in 2009. IZ requires a certain percent of square footage to be used for affordable housing and allows developers to get up to 20 percent additional density.

Providing additional planning benefits simultaneously with affordable housing requirements, as D.C.'s program did, improves the financial feasibility of new development—making more affordable units feasible than would have been feasible without the new benefits. We recommend Minneapolis mirror this approach by adopting inclusionary housing in conjunction with the Minneapolis 2040 plan, which will likely provide additional planning benefits.

Applicability

The program applies to new residential development projects of 10 or more units. It also applies to rehabilitation projects that are expanding an existing building by 50 percent or more, resulting in an additional 10 or more units.

The IZ program applies citywide, but a few limited areas where it would not make sense to provide the bonus density are exempt from the policy. These areas include:

- ▶ Areas with height restrictions due to the presence of the federal government, where zoning already maximized the allowable height. This includes much of downtown and the area near Union Station.
- ▶ Neighborhoods where bonus density would not be compatible with an existing historic district. This includes portions of Georgetown and the Anacostia historic district.
- ▶ Small areas of federal interest, including the historic gate to the Navy yard.

Affordability and Incentives

IZ allows developers to get up to 20 percent additional density and requires a certain percent of square footage to be used for affordable housing. Requirements are lower for projects that use steel- or concrete-frame construction because those construction types are more expensive to build. Steel- or concrete-frame buildings must dedicate the greater of 8 percent of residential square footage or 50 percent of the bonus density that's achieved on the site. Wood-frame buildings must dedicate the greater of 10 percent of residential square footage or 75 percent of the bonus density. Projects that receive the maximum bonus can end up providing as much as 12.5 percent of the square footage of the entire building (including bonus density) as affordable housing. The bonus density is calculated based on the entire square footage of the building (residential + commercial) to avoid penalizing a developer for creating a mixed-use building.

It is notable that even in Washington, D.C., where many neighborhoods have a very strong housing market, the percentage requirement is relatively modest (below 15 percent).

Rental units must be affordable to households earning up to 60 percent median family income (MFI). Ownership units are targeted to 80 percent MFI. However, the square footage set-aside applicable to an inclusionary development that only has ownership units may be reduced by 20 percent if all the affordable units are set aside to households earning 60 percent MFI or below.

Units must remain affordable for the life of the project. The rationale is that because the bonus density will be there for the life of the project, the affordable units should be as well. This long affordability term reflects current best practices for inclusionary housing programs; Grounded Solutions Network recommends that Minneapolis seek to maximize the term of affordability in its inclusionary housing policy to the extent permitted by Minnesota statute.

The IZ program in Washington, D.C., does not have an in-lieu fee option; the district saw inclusionary housing as the best way to achieve fair housing goals of providing low-income households access to high-opportunity neighborhoods by requiring inclusionary units to be built on site.



Results

From the inception of the program in 2009 to September 30, 2017, a total of 594 inclusionary units have been produced across 73 developments. Another 797 units are in the pipeline as of March 2018, for a projected total of 1,391 inclusionary units built or in the pipeline.

To put that number in perspective, D.C. saw a total of 14,419 housing units in 165 projects built or in the pipeline during this same time period, so 10 percent

of all housing units were affordable units generated through the IZ program. This robust affordable housing production number can be attributed primarily to the mandatory nature of D.C.'s program, illustrating one of the reasons we recommend Minneapolis link the provision of affordable housing to discretionary land use approvals, rather than use a purely voluntary approach.



Case Study — Chicago

Chicago's Affordable Requirements Ordinance (ARO) was created in 2003 and originally applied to any development receiving financial assistance or discounted land from the city. The ARO was revised in May 2007 to apply to a broader range of projects.

Applicability

The ARO applies to developments of 10 units or more if:

- ▶ A development receives city financial assistance or involves city-owned land
- ▶ A zoning change is granted that increases project density or allows a residential use not previously allowed
- ▶ The development is a planned development within the downtown area

The addition of the zoning change criterion greatly increased the number of projects subject to the ARO. As described earlier in this report, linking affordable housing to zoning changes is unlikely to be effective in Minneapolis given the current planning and development context in the city.

In 2015, the ARO was amended to create three zones in the city to reflect different housing markets and priorities: downtown, higher-income areas and low-moderate income areas. Chicago has a set of 77 previously designated census-tract-based areas called "community areas." Each community area outside of downtown was given a designation of higher-income or low-moderate income, based on whether the total area of higher income census tracts or the total area of low-moderate income census tracts is higher. In-lieu fees differ among these three zones.

In 2017, Chicago created two three-year ARO pilot programs to increase requirements and remove the in-lieu fee option in two gentrifying areas (Milwaukee Corridor and Near North/Near West).

This geographic variance worked in Chicago because the "community area" boundaries had been drawn decades ago, and because the designation was based on quantitative census data. These two factors reduced the level of controversy around which areas fell into which zone. Minneapolis lacks a similar existing set of neighborhood boundaries to delineate different housing markets, making a geographically varied policy more challenging to implement.

Affordability and Incentives

Developments subject to the ARO must set aside 10 percent of residential units as affordable housing or pay a fee. For projects receiving financial assistance from the city, 20 percent of the units must be affordable. Grounded Solutions Network's policy recommendation for Minneapolis mirrors this approach, in which developers have two options for compliance: a lower affordable housing set-aside with no subsidy or a higher set-aside with subsidy.

Rental units must be affordable to households earning up to 60 percent of AMI, and for-sale units must be affordable to households earning up to 100 percent of AMI. If a project receives financial assistance, half of rental units must be affordable at 60 percent AMI, half at 50 percent AMI; half of ownership units must be affordable at 100 percent AMI, half at 80 percent AMI. Projects may build less than the required percentage of affordable units if they build ownership units affordable at 80 percent AMI.

Developments have the option to pay a per-unit fee to the city's Affordable Housing Opportunity Fund. Under the 2007 ordinance, fees were \$100,000 per required affordable unit. In 2015, in-lieu fees increased to \$175,000 downtown and \$125,000 in higher-income areas; and they were reduced to \$50,000 in low-moderate income areas.

As of 2015, one-fourth of the required affordable units are required to be provided as on-site housing units, with two exceptions:

- ▶ Off-site option: Developers in higher-income areas and downtown may meet the requirement to provide one-fourth of the required affordable units by building, buying or rehabilitating units off-site.
- ▶ Buyout for downtown for-sale projects: For-sale projects downtown may buy out of the on-site or off-site unit requirement by paying a \$225,000 in-lieu fee per required unit.

For the 2017 pilot areas, no fee option is permitted. In the Milwaukee Corridor and Near West areas, developments must set aside 15 percent of units as affordable (20 percent if receiving TIF); the requirement increases to 20 percent of units in the Near North area.

Units built under the ARO must be kept affordable for a period of 30 years. For-sale units produced prior to the creation of the Chicago Community Land Trust (CCLT) in 2006 have recapture mortgages to regulate the long-term affordability. At the time of purchase, the city records a 30-year lien for the difference between the unit's market price (at the time of purchase) and its affordable price. When units are sold, the seller must repay this lien plus 3 percent per year interest.

For-sale units produced since 2006 are managed by CCLT. These units will have a 30-year restrictive covenant with a maximum resale price; the 30-year term does not renew at each time of sale. The maximum resale price (within the 30-year period) will be the original purchase price plus a percentage of the market appreciation, and in most cases will be a below market price. The owner of the affordable unit at the expiration of the 30-year

affordability period has the option of paying an amount equal to 50 percent of the difference between the affordable unit's market value and its affordable price, as determined at the time of such sale, or selling the unit to an eligible household at an affordable price, subject to an affordable housing agreement in the city's then-current form. However, if the owner of the affordable unit occupies the affordable unit as his or her principal residence for a continuous period of 30 years, the city will release the affordable housing agreement without further obligation on the owner's part.

The requirements that trigger the ordinance (such as zoning changes that increase density and financial assistance from the city) can be considered incentives or regarded as compensations built into the program.

The 2015 changes to the ARO included a new density bonus provision to encourage on-site units near transit. Projects in a transit-served location may receive additional floor area in exchange for providing 50 percent or 100 percent of required affordable units on site.

In addition, the affordable units created through the ARO are indirectly eligible for a property tax reduction because their assessment is based on the restricted sale price rather than the market value.

Results

Since 2007 through Q1 2018, the ARO has applied to 162 projects, produced a total of 596 units, and collected \$83 million in in-lieu fees. Data was not easily available to translate fees received into units produced, or to compare market-rate housing production with affordable housing produced through the ARO.



Case Study — Seattle

Seattle had a voluntary inclusionary housing program in place for many years and recently switched to primarily rely on a new mandatory affordable housing program. This case study describes both programs.

Voluntary Incentive Zoning

Seattle's Voluntary Incentive Zoning (VIZ) program allows developers to gain extra floor area for their commercial or residential development projects in exchange for contributing to affordable housing (either building units or paying an in-lieu fee). Launched in 1985, the program initially focused on commercial development; a housing bonus program was first adopted for certain downtown areas in 2006.

Applicability

VIZ applies in areas where rezones have allowed additional development potential. These areas include the Downtown and South Lake Union urban centers and other areas of the city that have been upzoned since 2006, including the Chinatown-International District and surrounding areas and portions of the University District, Uptown and North Rainier.

VIZ applies to projects above a certain minimum height threshold (rather than above a minimum unit count, which is the more common metric). Thresholds differ by area and calculations are done on a project-by-project basis.

Affordability and Incentives

Seattle's VIZ program requires developers to devote a certain square footage of their development to affordable housing (specifically, 14 percent of the gross square footage of bonus floor area that they receive under the program using the default affordability levels, or 8 percent of the bonus floor area if units are affordable at 50 percent of AMI). The requirements result in roughly 5 percent of units being affordable in residential projects that utilize the full available bonus.

The payment of a fee in lieu of providing units is allowed in some areas, including the Downtown and South Lake Union urban centers.

Currently, for on-site performance, rental units are targeted at households making up to 80 percent of AMI, and ownership units are targeted at up to 100 percent of AMI. Developers have the option to build units serving households at 50 percent of AMI in exchange for a lower affordability requirement. Units must remain affordable for a 50-year period. In-lieu fees tend to be leveraged with other forms of affordable housing funding (such as low-income housing tax credits) and serve households at 60 percent AMI or lower.

Results

From 2006 to 2017, the VIZ program produced 229 on-site units, and it collected \$130 million in fees from both residential and commercial development. Using Office of Housing methodology, an estimated 1,642 affordable units were created that would otherwise not have been built without these VIZ payment funds. So, in total, the VIZ program is estimated to have produced 1,871 affordable units between 2006 and 2017, or an average of 156 units/year.

To put that number in perspective, Seattle issued permits for roughly 69,000 housing units between 2006 and 2017, so less than 3 percent of all housing units were affordable units generated through the VIZ program. In comparison, under the mandatory IZ program in Washington, D.C., roughly 10 percent of all housing units were affordable units generated through their IZ program. The relatively low affordable housing production in Seattle's VIZ program again illustrates one of the reasons we recommend Minneapolis link the provision of affordable housing to discretionary land use approvals, rather than use a purely voluntary approach.

There have been relatively few projects eligible for incentive zoning. And even among eligible projects, many have chosen not to take advantage of the bonus density. A 2014 economic analysis found that in many cases, even if developers had an option to achieve extra



density without affordable housing requirements, projects would not have used it. For example, if a lot is too small, it is not feasible to have a taller building, even if the zoning code allows it. In other cases, the additional cost associated with more expensive construction types for higher buildings was greater than the financial benefit of building higher. This illustrates some of the challenges of relying on increased density as an incentive for the voluntary provision of affordable housing.

Mandatory Housing Affordability

In response to the lackluster performance of the VIZ program and a worsening housing affordability crisis, Seattle is implementing a mandatory inclusionary housing program. In 2016, the city council adopted the framework for the Mandatory Housing Affordability (MHA) program.

Applicability

The approach behind MHA is that mandatory inclusionary housing requirements take effect when the Seattle City Council adopts new zoning that adds development capacity (increases maximum height or floor area ratio (FAR) limits or establishes a different zoning designation). MHA applies following both city-initiated legislative rezones and developer-initiated contract rezones. Providing additional planning benefits simultaneously with affordable housing requirements improves the financial feasibility of new development, making more affordable units feasible than would have been feasible without the new benefits. We recommend Minneapolis mirror this approach by adopting inclusionary housing in conjunction with the Minneapolis 2040 plan, which will likely provide additional planning benefits.

In zones where VIZ can currently be used to achieve extra floor area, and where MHA is later implemented as a result of zoning changes that increase development capacity, affordable housing requirements for achieving extra floor area will automatically be satisfied by complying with MHA.

MHA will apply in all multi-family and commercial zones, and in all urban villages, consistent with the Seattle 2035 Comprehensive Plan adopted by the city

council. In other words, the city chose the geographic areas in which the policy would be applied based on existing boundaries from an existing land use plan. Using existing geographic boundaries reduced the level of controversy around determining to which areas MHA would apply. Minneapolis lacks a similar existing set of neighborhood boundaries to delineate different housing markets, making a geographically varied policy more challenging to implement.

In 2017, MHA was put in place in six neighborhoods (Uptown, Chinatown-International District, three nodes in the Central Area, the University District, Downtown and South Lake Union). The council expects to vote to implement MHA—including both the affordable housing requirements and new zoning capacity—for the remaining areas in fall 2018. This would apply MHA requirements to 27 urban villages and other areas with commercial and multi-family zoning throughout the city.

Within the areas where MHA applies, there is no minimum project size threshold.

Affordability and Incentives

MHA requirements vary both based on geographic area of the city and on the scale of the zoning change. Higher MHA requirements apply in areas with higher housing costs and larger zoning changes. First, the city is divided into low-, medium- and high-cost areas, established by analysis of independent rental market survey data. Within each of those three MHA areas, the specific requirement varies further based on whether the zoning change results in a zone within the same category, in the next highest category, or in a category two or more categories higher.

With the performance option, between 5 percent and 11 percent of homes in new multi-family residential buildings are reserved for low-income households. With the payment option, development will contribute between \$5.00 and \$32.75 per square foot.

For rental homes, requirements differ by unit size. For rental units of 400 square feet or less, units must serve households with incomes up to 40 percent of AMI at initial certification and up to 60 percent of AMI at annual recertification. For rental units larger than 400 square feet, units must serve households with incomes up to 60 percent of AMI at initial certification and up

to 80 percent of AMI at annual recertification. For-sale homes must be sold only to households with incomes up to 80 percent of AMI. Payments will be used to support housing for renter households with incomes at or below 60 percent of AMI, or owner households with incomes at or below 80 percent of AMI.

Housing provided through the performance option must remain affordable for 75 years. This long affordability term reflects current best practices for inclusionary housing programs; Grounded Solutions Network recommends that Minneapolis seek to maximize the term of affordability to the extent permitted by Minnesota statute. For homeownership, the resale price (after the initial sale) will be calculated to allow modest growth in homeowner equity while maintaining long-term affordability for future buyers.

Results

Seattle has set a goal for MHA to create at least 6,000 new rent- and income-restricted homes for low-income people by 2025, or roughly 665 units per year. Between 2006 and 2017, the city permitted roughly 5,750 units per year. If that pace of development continues, and if the city's MHA goals are met, that would mean roughly 12 percent of units will be affordable units generated through MHA—a significant improvement over the 3 percent of units annually generated through Seattle's Voluntary Incentive Zoning program.



Appendix Financial Feasibility Analysis Detailed Tables

Project Attributes

(Base Projects - No Affordability or TIF)

Wood-frame Rental

Location	Downtown	Strong markets	Emerging markets	Soft markets
Project				
Units	100	100	100	100
Net Parking Ratio	1.00	1.00	1.00	1.00
Average Unit Size	765	765	765	765
Commercial Space	-	-	-	-
Common Area	10,432	10,431	10,432	10,431
Total Project Square Feet (exc. Parking)	86,929	86,929	86,929	86,929
Revenue				
Average Residential Rent Per Foot	\$2.48	\$2.42	\$2.09	\$1.75
Commercial/Parking/Other Income per month	\$30,000	\$30,000	\$30,000	\$30,000
Gross Potential Income (annual)	\$2,640,000	\$2,577,000	\$2,280,000	\$1,967,854
Vacancy and Operating Expenses	-\$1,009,800	-\$985,703	-\$872,100	-\$752,704
Net Operating Income (NOI)	\$1,630,200	\$1,591,298	\$1,407,900	\$1,215,150
Cost				
Land Cost Per Unit	\$27,500	\$22,500	\$10,000	\$8,000
Construction Cost (inc. Parking) per unit	\$192,666	\$192,665	\$192,624	\$192,665
Total Development Cost (TDC)	\$25,933,026	\$25,412,599	\$24,107,038	\$23,903,729
Cost (TDC) per unit	\$259,330	\$254,126	\$241,070	\$239,037
Yield				
Yield on Cost (NOI/TDC)	6.29%	6.26%	5.84%	5.08%



Mid-rise Rental

Location	Downtown	Strong markets	Emerging markets	Soft markets
Project				
Units	150	150	150	150
Net Parking Ratio	1.00	1.00	1.00	1.00
Average Unit Size	824	824	824	824
Commercial Space	-	-	-	-
Common Area	21,804	21,804	21,804	21,804
Total Project Square Feet (exc. Parking)	145,358	145,358	145,358	145,358
Revenue				
Average Residential Rent Per Foot	\$2.55	\$2.49	\$2.34	\$2.01
Commercial/Parking/Other Income per month	\$-	\$-	\$-	\$-
Gross Potential Income (annual)	\$3,780,000	\$3,691,200	\$3,463,200	\$2,978,400
Vacancy and Operating Expenses	-\$1,086,750	-\$1,061,220	-\$995,670	-\$856,290
Net Operating Income (NOI)	\$2,693,250	\$2,629,980	\$2,467,530	\$2,122,110
Cost				
Land Cost Per Unit	\$25,000	\$25,000	\$10,000	\$8,000
Construction Cost (inc. Parking) per unit	\$231,001	\$231,001	\$231,001	\$231,001
Total Development Cost (TDC)	\$46,893,220	\$46,893,220	\$44,514,070	\$44,196,850
Cost (TDC) per unit	\$312,621	\$312,621	\$296,760	\$294,646
Yield				
Yield on Cost (NOI/TDC)	5.74%	5.61%	5.54%	4.80%

Highrise Rental

Location	Downtown	Strong markets	Emerging markets
Project			
Units	200	200	200
Net Parking Ratio	1.00	1.00	1.00
Average Unit Size	843	843	843
Commercial Space	5,000	5,000	5,000
Common Area	29,736	29,736	29,736
Total Project Square Feet (exc. Parking)	203,243	203,243	203,243
Revenue			
Average Residential Rent Per Foot	\$2.61	\$2.58	\$2.21
Commercial/Parking/Other Income per month	\$150,000	\$135,000	\$135,000
Gross Potential Income (annual)	\$7,080,000	\$6,846,000	\$6,090,000
Vacancy and Operating Expenses	-\$2,170,020	-\$2,098,299	-\$1,866,585
Net Operating Income (NOI)	\$4,909,980	\$4,747,701	\$4,223,415
Cost			
Land Cost Per Unit	\$35,000	\$27,500	\$10,000
Construction Cost (inc. Parking) per unit	\$286,634	\$286,634	\$286,634
Total Development Cost (TDC)	\$78,169,235	\$76,583,135	\$72,882,235
Cost (TDC) per unit	\$390,846	\$382,916	\$364,411
Yield			
Yield on Cost (NOI/TDC)	6.28%	6.20%	5.79%