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What Have We Learned From The Great Recession?**

**Fisher Center for Real Estate and Urban Economics
Working Paper
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Cynthia A. Kroll, Christina Mun, Larry Rosenthal, Vishali Singal

**Fisher Center for Real Estate and Urban Economics and Berkeley Program on
Housing and Urban Policy**

Abstract

Numerous California cities and counties impose “below market rate” (BMR) inclusionary requirements on residential builders. The stated purpose of such ordinances is to increase the supply of affordable housing by adding price-restricted units to market-rate projects. This paper examines the effects of BMR requirements on residential development in weak real estate markets. We review relevant literature, conduct case studies of seven California communities, and interview California builders. Irrespective of boom or bust, there is no published evidence that California BMR requirements reduce total housing production, but the mix of housing may be affected, shifting the balance towards multifamily over single family housing in communities with such measures, the price level at the upper end of the market may increase, and price level and unit size at the low end may decrease. We find that the recent weakening of the housing market indeed places strain on many of the state’s BMR programs, as the price gap between market rate and income-restricted housing has narrowed and the sale of BMR homes, which carry resale restrictions, is more difficult. Builders express concern that aggressive BMR programs might slow recovery in the residential construction sector. As jurisdictions adjust to market realities, smart practices include (1) flexibility of BMR requirements in the face of weak demand and falling prices, in terms of number of units, affordability levels, or use and resale restrictions; (2) substitute compliance alternatives, such as off-site development and in-lieu payments; and (3) good faith negotiation among jurisdictions and builders, marked by cooperation and consideration of macroeconomic circumstances.

Below Market Rate Requirements in a Down Market: What Have We Learned From The Great Recession?

Requirements for the inclusion of “below market rate” (BMR) units in new developments are used widely in communities throughout California for the stated purpose of increasing the supply of affordable housing. Such laws obligate developers to add price-restricted units to their projects, benefiting income restricted buyers and tenants, as a condition for receiving the entitlement to build. Theoretical analysis raises questions about these laws, and their efficacy, and impacts on local and regional housing markets remain open questions empirically.

The Non-Profit Housing Association of Northern California and the California Coalition for Rural Housing estimate that BMR, or “inclusionary,” requirements by 2006 had led to at least 37,000 additional affordable units added throughout the state under the ordinances (CCRH/NPH 2003, NPH *et al* 2007). Schuetz, Meltzer and Been 2009 estimate that two to three percent of housing units built in the San Francisco Bay Area between 1980 and 2006 were affordable units added through inclusionary requirements. Other research suggests BMR requirements may lead to fewer or more expensive new housing units built overall or may affect the mix or location of new construction.

Most new affordable units have been built in periods of prosperity and strong building activity. Many BMR measures apply in communities that have other requirements that affect the pace, type, or cost of new housing development (such as restrictions on lot size, building height, and location). In prosperous times, a BMR measure may become simply one more fee or requirement imposed in restrictive markets that, once entered, provide a captive set of consumers vying for a limited housing product. Through a combination of adjusting product mix, prices, timing and location of

different elements of the project, a builder may find that BMR units can be comfortably added to a new development while still allowing competitive returns.¹ Yet these options may no longer pencil out when the larger economic conditions change.

The Current Downturn

Between 2007Q2, when California median home prices peaked at close to \$590,000, and 2009Q3, the median price dropped by over 50 percent. The Federal Housing Finance Agency (FHFA) repeat-sales index, a measure of same-home value change, dropped by 36 percent between its 2006Q4 peak and 2009Q2. Unemployment rose above 12 percent by September 2009, and real earnings were further affected as large public employers began to use furloughs to reduce the numbers of layoffs. Real estate markets have been slow to recover, and new projects on the drawing board at the boom's peak have been mothballed for now.

The collapse of the construction economy provides apt opportunity to examine BMR measures anew. Numerous questions loom concerning the design and practice of inclusionary zoning during bust cycles (referred to in our title as “down markets,” when residential real estate prices have dropped, capital is scarce, and builders have cut back sharply). When the flow of development investment is already at a near standstill, added regulatory costs are especially unwelcome as investors weigh their already constrained options. In particular, the following questions motivate our inquiry regarding BMR practice in down economies:

¹ Impacts on the overall housing stock and the provision of affordable housing are a separate question from feasibility of the project for the developer. These broader impacts are discussed later in the paper.

- Do BMR measures continue to require the type of unit that would not otherwise be built in California communities, or have declining prices caught up with the required affordable levels of housing?
- At what point during the worst down-markets do BMR requirements in fact prevent new projects from pencilling out?
- Do BMR jurisdictions make reasonable adjustments when capital is scarce, allowing projects to move forward? If such adjustments are permissible, and such discretion is exercised, how exactly does regulatory practice change to accommodate new market conditions?
- Does the current experience inform us further on “best practices” for inclusionary zoning?²

We explored this topic through several means. We begin with a more detailed description of BMR measures, to provide a common ground for understanding. The next section of the paper summarizes existing research on inclusionary zoning in California and beyond. We give a brief history of the measures in California, synthesize findings from several studies, and discuss the effects of market conditions on the demand for market rate and BMR housing. The second part of the paper presents case studies of communities with BMR requirements; we find considerable diversity in how such measures have been implemented how local economic conditions have changed during the economic crisis, and what lessons can be distilled concerning promotion of affordable housing going forward. The third section of the paper presents our findings from a set of

² A note on terminology. We use the term “inclusionary zoning” because that is accepted terminology for a specific class of land use regulations. For all other aspects of the measures, we use the term “below market rate” (or BMR), because it is more descriptive of what is required and less value laden in terms of implying a specific demographic or income mix outcome.

confidential interviews with for-profit and non-profit builders operating in BMR communities, highlighting the effects of the current economy and BMR “best practices.” The paper concludes with a review of key findings and directions for research going forward.

BMR Requirements

The basic distinguishing feature of a BMR requirement is the directive that builders supply more new, affordably-priced units than the unregulated market would supply. The actual form of these requirements can vary widely. In some communities, the BMR requirement is mandatory, while other jurisdictions make the process optional, usually through the use of incentives. Other characteristics that distinguish different types of BMR measures include:

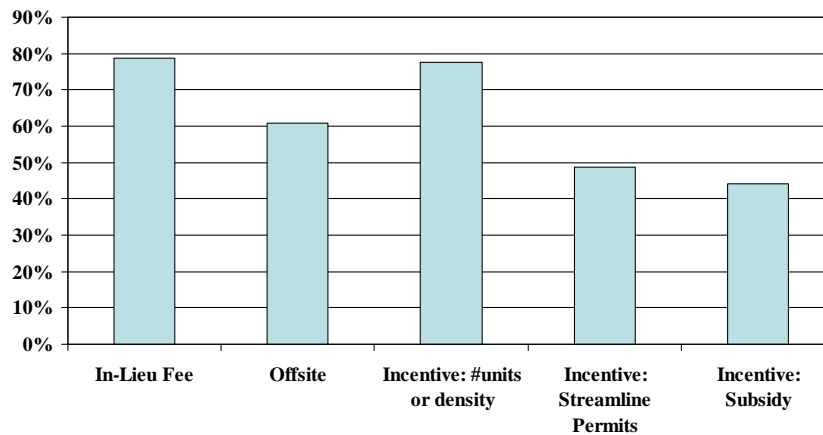
1. The percent of new homes required to be affordable
2. Maximum income levels for occupants
3. Alternative ways developer may meet the requirement (e.g., on-site units, off-site projects, in-lieu payments)
4. Incentives offered to offset the impacts of the requirement (e.g., density bonuses)
5. Duration of mandatory affordability.

(see CCRH/NPH 2004).

Based on data from a 2006 survey by the California Coalition for Rural Housing and the Nonprofit Housing Association of Northern California (NPH *et al* 2007), about 170 of 530 city and county jurisdictions in California have some type of BMR measure in place, with ninety percent making compliance mandatory as opposed to voluntary. Most

such jurisdictions offer alternative ways builders can incorporate affordable units within their projects, and many offer some type of incentive in conjunction with the BMR requirement, as shown in Figure 1.

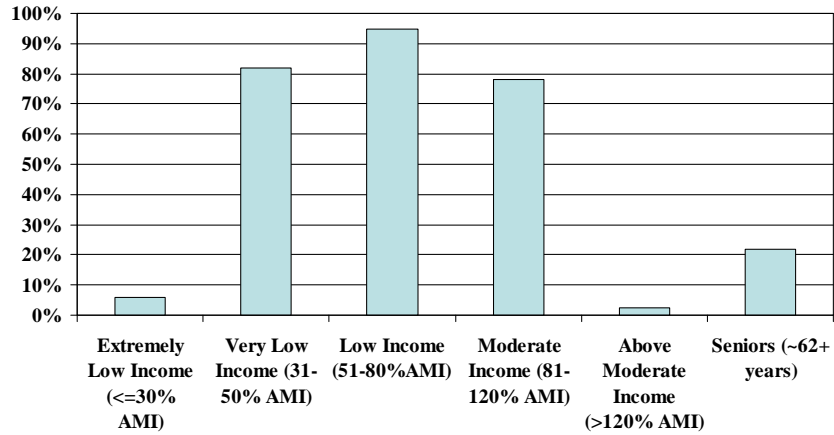
Figure 1
 Alternatives and Incentives in California Inclusionary Measures
 (Percent of all measures)



Source: Authors from CCRH/NPH survey, 2006.

The minimum-sized project to which the ordinance may apply varies from fewer than five units to 100 or more, and proportion required to be affordable varies from less than five to over sixty percent. The target population may include extremely or very low income (household income 30 percent or below Area Median Income, or 31 percent to 50 percent of Area Median Income), low income (51 to 80 percent of Area Median Income), moderate income (81 to 120 percent of Area Median Income), or above moderate income (above 120 percent of AMI and below a locally determined ceiling), as shown in Figure 2. About twenty percent of measures included senior residents (generally 62 and older) as one of the target groups.

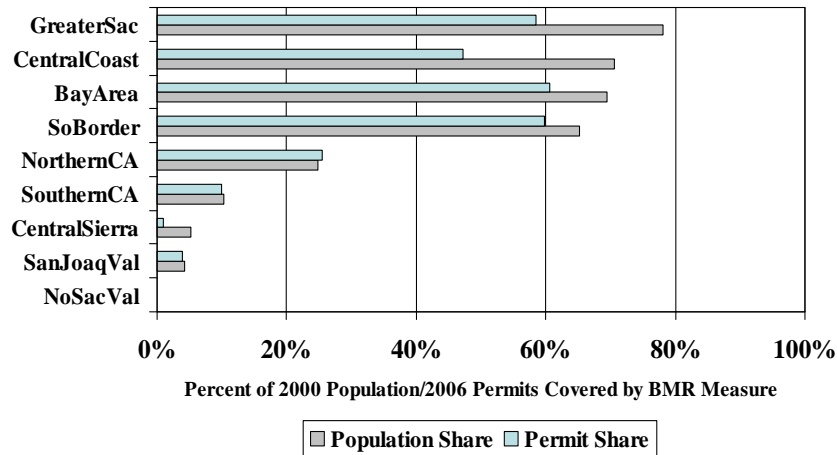
Figure 2
Target Income Population
(Percent of all measures)



Source: Authors from CCRH/NPH 2006 database.
AMI: Area Median Income

The implementation of BMR varies greatly across jurisdiction. Sources of variation include regulatory design, project type, presence or absence of nonprofit developer partners, land dedications and payment of in-lieu fees, and utilization of local and other subsidy sources. BMR units may be integrated within market-rate buildings; in such instances, the builder may cross-subsidize lower-cost units from higher-end product within the project. BMR units can also be placed on land donated by the developer, with that land dedication sufficing for compliance. Developers can pay in-lieu fees to satisfy the BMR requirement, leaving their market-rate buildings unaffected. In those cases the ultimate user of land and fees is often a nonprofit builder of tax-credit-based affordable construction. Rental units for qualifying households can be added to an ownership project. Such variation in regulatory practice and implementation complicates research considerably.

Figure 3
 Share of Population Base (2000) and Residential Permit Share (2006) Covered by Below Market Rate Measures as of 2006



Source: Authors from California Coalition for Rural Housing California Inclusionary Housing Policy Database, California Department of Finance Table E-5, and Construction Industry Research Board 2006 City Permit Data. Calculated based on measures that cover entire jurisdiction; specific plan area measures are not included.

Figure 3 shows the geographic concentration of inclusionary measures, adjusting for population size and level of permit activity. Just over thirty percent of the state’s population is in communities covered by BMR measures, or 27 percent of 2006 residential building activity. Geographically, BMR measures are concentrated most heavily in the Sacramento area, the San Francisco Bay Area, and the south border area (San Diego and Imperial counties). More than 50% of building activity and between about 60 and 80 percent of the population in these areas are covered by some type of BMR measure. Almost half of building activity in central coastal areas is covered by BMR measures, but a much smaller share of building activity in other parts of the state, at the time of the CCRH/NPH survey, was subject to BMR requirements,³

³ This estimate of coverage includes only city-wide coverage of coverage of all non-city jurisdictions within a county. Thus, for example, the City of Los Angeles is considered in this table to have no BMR measure coverage, although the “Palmer” case, mentioned later in this report, addresses a BMR requirement in a small redevelopment district within Los Angeles.

Although California is frequently the site for studies of BMR impacts, the state has no legislation expressly or implicitly authorizing inclusionary zoning ordinances (Hollister *et al.* 2007). Thirteen other states and the District of Columbia have such enabling measures, while two states, Texas and Oregon, explicitly prohibit the use of BMR measures. The great majority of states, like California, provide the functional equivalent of “home rule,” under which individual jurisdictions decide on their own zoning absent any specific statewide restrictions to the contrary.

The variety of BMR ordinances and the diverse nature of communities where they have been adopted makes statistical analysis particularly challenging. Not only may individual characteristics influence the impacts of the measure, but the combination of characteristics and the interaction of these characteristics with other community factors could also affect outcomes. For example, Petaluma’s measure is part of the housing element, rather than a separate ordinance, has been in place since 1984, allows alternatives such as in-lieu fees and land dedication, and requires different income level targets for rental (very low and low) versus homeowner units (low and moderate). Of units produced from 1999 to 2006, about half were included in projects and half through in-lieu measures. In contrast, Santa Rosa has a separate BMR ordinance adopted in 1992. Rental units are targeted for very low and low, and ownership just for low income). Santa Rosa also allows a range of alternatives and similar incentives to Petaluma, but 95 percent of units produced have been through in-lieu fees. (CCRH survey)

Findings from Past Research

There are several approaches to understanding the effects of BMR requirements on the housing market. We begin by briefly reviewing the theoretical arguments. We then

turn to considering three types of studies: a) estimates of the production of affordable housing, which explore the operation of BMR measures and track affordable construction directly attributable to them; b) accounting analyses, which use pro formas to illustrate how market conditions and other factors affect the impact of BMR measures on project feasibility; and c) descriptive and statistical analyses which examine broader impacts on the housing market in terms of building activity (level and product mix) and price.

Conceptual Views of BMR Measures

Theoretical discussions of the impact of BMR, beginning with Klevens (1974), focus on the role of the characteristics of the measures and the local and surrounding markets in determining their impacts. A BMR measure with no adjustments to offset costs, and no flexibility in how the requirement is applied (for example giving the builder choice in factors such as rental or for sale affordable units, on-site or off-site, affordability level, density tradeoffs), can be viewed as a tax (Dietderich 1996). Even under these conditions, builders may still find it profitable to develop housing, if a portion of the costs can be passed on to the landowner, added to the price faced by eventual buyers of market-rate housing, or supported via other subsidy (Kleven 1974). Cross-subsidy is particularly feasible where tight building restrictions in surrounding markets restrict buyers' options. Otherwise, the number of units built may decline, prices may rise, and the construction mix may shift towards commercial uses (see Clapp 1981).

Density bonuses are the most frequently mentioned offset to the cost of BMR requirements. Granting project-based exceptions to density limits – often via relaxed height or lot-coverage limits - allows more intense use of land, sometimes keeping new construction profitable despite regulated prices (Clapp 1981, Dietderich 1996).

Geographic characteristics of the area may also be relevant to the feasibility of different types of offsets, however. For example, Klevens hypothesizes that in more urban areas, such as downtowns, added densities may actually increase costs, by shifting residential construction into taller high-rise buildings.

BMR measures induce other shifts in building mix. Voluntary BMR ordinances with density bonuses can serve to reduce investment in single-family projects (Dietderich 1996). Builders choosing not to pay the “tax” of BMR units instead build custom units, undertake rehabilitation work, or shift toward nonresidential construction. The approach could also undermine the evenness of the price structure, providing low- and high-priced units at the expense of homes in the mid- to high-mid ranges (Clapp 1981). Much depends on the sophistication of practice, however. Where incentives and alternatives are strong enough, and implementation flexible enough, even a voluntary ordinance can increase building of both market rate and BMR units (Schuetz *et al.* 2007), particularly during a boom cycle in the regional economy.

Analysis of BMR regulations is often value-laden, and the framing of the discussion may influence the assessment of such ordinances’ effects. For example, as Dietderich points, terming effects on builders’ profit margins as a “tax” ignores the ways BMR differs from other types of taxes, such as an infrastructure tax. Instead, if the BMR requirement includes density increases in areas where “exclusionary” zoning is in place (*e.g.*, large-lot zoning), Dietrich argues the combination could occasion a net reduction in taxation (1996:42). In contrast, other analyses start with the assumption that the market is at equilibrium, BMR operates in isolation, and its addition necessitates new costs (and reduced profits).

Hughes and Van Doren 1980 point to the social objectives of the BMR approach introduced in New Jersey after the *Mount Laurel* decisions, but indicate that it may not be an efficient solution. The authors express concern that excess cost paid by developers (and passed on to buyers) will exceed benefits received by consumers of affordable housing and point to resale restrictions as critical to extending the benefits of income distribution beyond the first sale. They also highlight other possible inequities that may occur when targeted groups are defined by income level, with possible perverse effects on other segments of the low income housing market.

Hughes and Vandoren further expand on the importance of market characteristics. They conclude that income redistribution through housing price-change can only occur where the supply of market-rate housing is stably less than demand. In such circumstances new homes can bear the “surcharge” BMR represents.

For our purposes, these conceptual discussions indicate that the impact of a given BMR measure depends very much on its stringency, the offsets provided, and the market characteristics of the existing community and surrounding areas. Alternatives available to either builders or buyers will influence the impact of the measure on the amount of housing built, the characteristics of the housing, and the price of units. Empirical studies have tested these conjectures, examining the effects of BMR measures on affordable and market-rate housing production, the mix of new construction, and housing prices.

Affordable Housing Production

Affordable housing production can be addressed through *output* measures (the level and share of all new housing that is affordable and attributable to the ordinance), or through *input* measures (characteristics of the ordinance, or of local construction markets, that influence the affordable housing production levels reached).

Output studies may address absolute levels of construction of affordable units, relative levels (as a share of all new building), or levels for specific target groups. The numbers cited in the introduction—over 30,000 units attributable to such measures in California (NPH), or levels on the order of two to three percent of new housing between 1980 and 2006 (Schuetz *et al.*)—suggest that overall impacts are marginal compared to the California housing stock as a whole. However, a Nonprofit Housing Association report based on the CCRH/NPH survey indicates that this average masks some very effective measures that have produced both high levels of BMR housing and high shares of BMR in new housing production (as self-reported by cities). Table 1 lists the jurisdictions defined as “top-producing” by the NPH study. Carlsbad, for example, produced over 1200 units, almost 100 per year, between 1993 and 2006, about 12 percent of all units permitted. Davis added BMR units at about half that level—50 per year—but the below market rate units accounted for over one third of all units added. Similarly high shares of BMR out of total units permitted are found in Petaluma (since 1984) and San Bruno (since 2003).

Table 1: California Jurisdictions Producing Largest Numbers or Shares of BMR Units				
City	Year Adopted	Total BMR Units Permitted	BMR % of All Units Permitted	Average Yearly BMR Units Produced
Petaluma	1984	587	34.0%	27
Davis	1987	945	33.9%	50
Emeryville	1990	382	20.3%	24
Carlsbad	1993	1246	12.1%	96
Dublin	1996	814	14.3%	81
Pleasanton	2000	360	16.4%	60
Atascadero	2003	224	20.4%	75
San Bruno	2003	325	36.2%	108
Source: NPH <i>et al</i> 2007				

The evidence on BMR’s efficacy in aiding targeted populations appears to vary over time and by author. The study by Calvita *et al.* (1997), comparing inclusionary practice in California and New Jersey, concluded that the California measures, by emphasizing households in the range of 80 percent of area median income, insufficiently addressed lower-income housing needs. Yet NPH *et al* 2007 found that while less than 20 percent of units produced through older programs in California serve the very-low income population, 47 percent of units produced through newer programs serve this same population group.

Several studies relate inputs to the production of affordable housing. Flexibility was found to be positively correlated with production of affordable housing by Schuetz *et al.* (2007) (in liberalized application toward small projects, or in expanded density incentives where appropriate) and Calavita *et al* (1997; in providing in-lieu alternatives to placing BMR units on-site). The characteristics of the housing market (e.g., availability and cost of developable land, presence of able and willing developers, and sheer political will) also appear to help BMR become more effective in producing affordable units

(NPH *et al* 2007). Additionally, extending the duration of guaranteed affordability boost the policy's chances of success (Brown 2001). Finally, making the policy mandatory increases its effectiveness in terms of the number of affordable housing units built (Brunick *et al.* 2004).

Feasibility of Production

Keyser Marston (2006) tested the impact of inclusionary zoning amendments on construction feasibility in San Francisco. The authors evaluated the impact of a) increasing the on-site compliance share from ten to fifteen percent of proposed units and in-lieu or off-site compliance from fifteen to twenty percent, and b) lowering the income level used to calculate the affordable unit price, based on defined threshold levels for return on cost and annualized return on equity, varied by product type. They found that tightening on-site compliance rendered three out of four prototype product types infeasible, while the adjusted in-lieu or off-site alternatives were feasible for all four product types. Impacts of income adjustments on project returns were much less significant across all project types than the effect of expanding the percentage of units required. The study's sales-price sensitivity analysis concluded that feasibility was dependent on a four to five percent increase in the sales price of market-rate units, whether by setting a higher price on the original product, if borne by the market, or by switching to higher end units to increase revenue. The finding regarding needed price boosts are particularly relevant for predicting impacts in down markets, when such price increases are likely to be infeasible.

Broader Housing-Market Impacts

Keyser Marston 2006 discusses conceptually why tightened BMR measures can reduce production of new housing. Other studies empirically test whether BMR measures reduce new home construction and/or raise new home prices. The results have been inconsistent, but a few stand out, relating to building activity and prices.

1. Effects on Building Activity. Most studies found no statistically supportable evidence in California that the presence of BMR measures decreases total housing production. Rosen (2002) found that, for 28 California cities between 1981 and 2001, institutional and economic conditions affected building activity, while BMR measures were a not significant factor. Knapp *et al* (2008) conclude jurisdictions with BMR measures did not differ significantly in the amount of new construction between 1988 and 2005, when other control factors are taken into account. However, the mix of housing changed, with an increase in the share of new housing in multifamily structures and a decrease in the share built in single-family projects. Schuetz *et al* found no significant change in building activity in either the San Francisco Bay Area or Washington DC due to BMR measures, and with some inconsistent results for the Boston area. Only Powell and Stringham (2004), using a before/after descriptive statistics comparison, find a decrease in building activity following adoption of some type of BMR measure. However, Basolo and Calavita 2004 strongly criticize this study for its lack of statistical rigor and its failure to consider a range of different factors, including other building restrictions, that also affect building levels.

2. *Price Effects*: Both the Powell and Stringham and Keyser Marston studies argue conceptually that, because inclusionary regulation increases costs, either prices

must increase, building volumes must decrease, product mix must change, or some combination of these outcomes must occur. The Knapp *et al* study uses statistical tests of empirical data and finds that in California, there are price- and mix-effects, but no overall decrease in building. They further disaggregate the effect between market segments, and find that the price increase occurs at the high end of the market, while at the lower end, prices drop slightly, but unit size also decreases. The Schuetz *et al* study found no evidence of a price effect for the San Francisco market, but a price increase in the Boston market.⁴

Implications for a Down Market

The existing empirical research has not directly addressed the implications of a change in economic conditions on the impacts of a BMR ordinance. Nevertheless, two elements of the previous discussion have particular implications for a down market. First, most studies find no statistically significant relationship between the ordinance and the level of building activity, but Rosen (2002) finds (not surprisingly) a significant effect of economic conditions on building activity. Thus, it is the economy, first, that would depress building activity in the current economic downturn. Second, the Hughes and Vandoren assertion that BMR requirements can be effective only in communities with supply constraints suggests that market conditions that reduce demand (and thus loosen supply constraints) may make it more difficult for builders to raise prices on market rate units to cover the added costs of the BMR segment of the project. Perhaps most importantly, the literature for the most part suggests that regulatory flexibility helps make

⁴ Neither Knaap *et al.* nor Schuetz *et al.* fully addresses a key challenge in measuring regulation's effect on price, namely, that it is uncertain whether price conditions produce certain kinds of regulation or regulation produces certain kinds of price conditions. This "simultaneity" – a familiar challenge in such research – does not undermine our case-study approach identifying variations in regulatory practice based upon recessionary market conditions.

BMR less costly and more effective. Such flexibility may be particularly warranted where the regulated class—in this case, developers of new housing units—already faces narrowed options due to the scarcity of capital and the paucity of demand due to slower job creation and regional economic growth more generally.

It is too early to conduct a detailed empirical study that can shed light on the differential impacts of the current economic downturn on communities with and without BMR requirements. Instead, we conducted a series of interviews with cities with BMR measures and with developers familiar with building in a range of California communities.

Adapting City BMR Measures to a Changing Economy

We selected the case-study jurisdictions of Fremont, Irvine, Pasadena, Sacramento, Salinas, San Marcos and Santa Clara to represent a mix of locations, demographics, densities, building trends and degrees of stringency in BMR requirements. Demographic and growth characteristics of these cities vary widely, as shown in Table 2.

Fremont and Pasadena are two built-out, infill cities, one in the San Francisco Bay Area and the other in Southern California, where new construction represents a relatively small share of total housing stock. Only 4.1% of Fremont's housing stock and 6.9% of Pasadena's have been added since 2000. Irvine and San Marcos are two very different suburban Southern California places, by such measures as income and household size, but each has added almost one third of housing stock since 2000. Sacramento and Santa Clara are two older urban places that are still seeing significant new housing production. Salinas, with an agricultural economic base, has slower building activity and large

average household size. Median household income and housing cost relative to income vary widely among the places studied.

City (County)	Region	Population 2009	Median Age 2006-08	Household Income 2006-08	Housing Units 2009	Percent Single Family 2009	Persons/ Household 2009	Percent Newer Units*	Rent as % of Income 2006-08
Fremont (Alameda)	Bay Area	216,636	37.4	\$94,979	72,390	70%	3.01	4.1%	25.9%
Irvine (Orange)	So.Cal.	212,793	33.0	\$94,903	79,039	54%	2.71	32.0%	29.5%
Pasadena (Los Angeles)	So.Cal.	150,185	37.2	\$64,184	58,135	52%	2.63	6.9%	31.4%
Sacramento (Sacramento)	Central	481,097	33.2	\$50,651	194,316	66%	2.58	15.6%	31.9%
Salinas (Monterey)	Mid Coast	152,597	28.4	\$51,615	42,595	62%	3.65	6.9%	30.8%
San Marcos (San Diego)	So.Cal.	83,149	31.9	\$63,109	27,726	55%	3.10	32.0%	34.4%
Santa Clara (Santa Clara)	Bay Area	117,242	34.9	\$85,571	44,729	50%	2.63	11.4%	25.0%
California		38.3 mil.	34.7	\$61,154	13.5 mil.	64%	2.94	9.7%	32.3%

Source: California Department of Finance, US Bureau of the Census
 * Percent of housing stock added since 2000.

Characteristics of Case Study Jurisdiction BMR Measures

As shown below in Table 3, BMR measures in these cities range in original adoption date, from 1977 to 2002. Project thresholds are quite low for all places studied—the measure applies to all projects in San Marcos and Irvine and to all projects with ten or more units in Pasadena, Salinas and Sacramento. Most offer a combination of incentives and alternatives, but stringency is also affected by the percentage of units that must be set-aside for affordability. The most common requirement is that 15% of units meet some measure of affordability (Fremont, Irvine, Pasadena, San Marcos, and Sacramento). However, the set-aside in Santa Clara alone ranges from as low as 10 percent for certain projects to as high as 50 percent. Of the three cities adopting their ordinances before 2000, two have revised the measures since 2000.

Place	Year Adopted/Revised	Density Bonus	Fee Deferral	Flexible Design	Fast track Permits	Subsidies	In-lieu Fee	Land Dedication	Off- Site	Credit transfer	Fee Waiver	Housing Conversion	Project Threshold	Percent Set-Aside	Target Population	Years duration of affordability
Fremont	2002	x	x				x	x	x				7	15%	Very low, low, moderate	Rental: Life Owner: 30
Irvine	1977/ 2003*	x		x	x		x	x		x	x	x	1	15%	Very low, low, moderate, senior	30
Pasadena	2001	x	x			x	x	x	x	x	x		10	15%	Low, moderate	Life
Sacramento	2000			x			x		x			x	10	15%	Very low, low	30
Salinas	1992/ 2005	x		x		x	x	x	x				10	20-35%	Very low, low, moderate, senior	30
San Marcos	2000	x	x			x	x				x		1	15%	Extremely low, very low, low, moderate	Rental: Life Owner: 55
Santa Clara	1992	x		x		x							5	10-50%	Very low, low, senior	10 to 30

* Irvine ordinance became mandatory in 2003.

The types of BMR units built, degree of integration in projects, and use of alternative approaches to providing affordable housing vary widely among our case-study jurisdictions. For-sale units are the primary BMR product built in Fremont and Santa Clara, while the other cities experience a mix of for-sale and rental BMR product. In-lieu payments are discouraged or not available in most of the case-study cities, but in Pasadena in-lieu payments to the city’s Inclusionary Housing Trust Fund are chosen frequently by developers of for-sale projects. These funds are typically combined with tax-increment funding in the redevelopment process, to support affordable projects built by nonprofit housing developers. Most of the cities stated a preference for on-site BMR units, and off-site is not even an option in either Salinas or Santa Clara. Partnerships

between for-profit developers and affordable-housing builders are common in half the cities studied; cities with these types of partnerships are also more likely to place BMR units off-site or in alternative sites within master planned developments.

Flexibility takes several forms in our case-study cities. Some places allow affordable rentals to satisfy the unit requirement from for-sale market rate unit developments. Irvine offers greater incentives toward supplying for-sale rather than rental BMR units. Salinas, San Marcos and Pasadena require fewer BMR units to be built, if the income category served provides deeper affordability. Sacramento only requires BMR units for rental projects, and only in specific portions of the city subject to planned unit development guidelines.

Flexibility can also be judged based upon the permitting process used. Negotiation of terms is built into some ordinances and either not offered or not a practical option in others. Negotiation may determine unit size, location and clustering (Fremont, Sacramento). Elsewhere, negotiation may be necessitated when project feasibility challenges warrant an in-lieu payment as an alternative (Irvine), altering the BMR price point (Santa Clara), or identifying alternatives to compliance (Salinas).

Jurisdiction Perspectives on Adjusting to a Weaker Housing Market

In higher-income communities such as Irvine and Pasadena, BMR requirements are not seen as a deterrent to development (when any building was feasible), at least as reported by city staff responsible for administering the regulation. Such ordinances may also have ancillary benefits. In Sacramento, city officials reported that, prior to passage of the BMR ordinance, affordable housing developers could not compete for land. They found that until the economic crisis, development continued regardless of BMR

requirements. Most city respondents reported that projects that stopped or slowed phasing during the economic downturn did so for economic reasons, not because of BMR requirements per se. Lack of sales and financing issues for either buyer or builder were the most frequently cited causes.

The market for affordable units has also slowed, as market prices have dipped closer to affordable prices. In communities where market rate units can be bought at price levels close to the affordability threshold, resale restrictions become a disincentive for buyers who qualify for BMR units. Possible adjustments addressing this condition vary by city. In some cases, easing restrictions on units (e.g., reducing the number of units required or broadening resale options for buyers of BMR units), or lowering the price of units (increasing the subsidy) are two possible responses, depending on the specifics of the market. In the case of Fremont, the ordinance allows units to be sold at market rate if there are no BMR buyers within 6 months of project completion. At the time of the interview, this had not occurred, but the city was working through the process more closely with potential BMR buyers. Further adjustments under discussion include a temporary moratorium on BMR requirements (Salinas), or case-by-case renegotiation for projects already in the pipeline (Sacramento).

This is a period of housing element review and update throughout the state, which may bring about further adjustments to these ordinances. (The state periodically reviews housing elements to determine if they provide for the community's "fair share" of affordable housing.) Several of the cities expected that there would be no weakening of the ordinances during the housing element review process, with the expectation that BMR measures would again be needed to meet state requirements once market conditions

improve. Sacramento and Salinas respondents mentioned the possibility of increasing flexibility, while Santa Clara indicated a possible reevaluation of need for the ordinance in light of the weaker market providing affordable units.

The city case studies highlight the value of flexibility and adaptability in implementing inclusionary zoning during the trough of the business cycle. The experience of a small number of cities is insufficient to provide any universal to-do list for jurisdictions with BMR regulations, but points to features that could be further explored over a larger number of other localities. Two considerations appear most pertinent: (1) increased sensitivity toward the special challenges facing developers during the market downturn and (2) creativity in attempting to both promote housing development and insure some proportion of new units are at prices accommodating lower-income buyers and renters. Our interviews with several California developers, discussed in the next section, help expand upon these elements.

Developer Perspective on BMR Requirements in a Down Market

Our builder interviews included market-rate and non-profit housing developers. The broad picture emerging from these interviews is as follows. When markets are strong in California, new development proceeds, and BMR requirements act as an additional, and often substantial, outlay among other fees imposed by the jurisdiction. Wherever they affect prospects for new constructions, BMR and other regulatory requirements are added into the cost basis for evaluating the feasibility of a given project. In the current downturn, the collapse in home prices, lack of credit, and oversupply of new product due to high-volume construction during the boom combine to slow building activity, regardless of whether there is a BMR requirement or not.

More detailed findings from our developer interviews also emerge.

Market-Rate and Affordable Developers Differ in their Attitudes Toward BMR

Demographics, employment, growth potential and degree of competition determine which market-rate developers enter which markets. In contrast, affordable housing developers focus on sites that will make them competitive for financing or on local jurisdictions where subsidies are available. The prevailing political climate influences both development categories, since likelihood of securing entitlements may depend on attitudes toward growth and preferences regarding housing mix. Within this context, a BMR requirement can have very different effects on for-profit market rate and affordable (often nonprofit) builders. BMR requirements add costs and narrow options for market-rate builders, but also may reduce the amount of competition in the market by discouraging other builders. For affordable housing developers, a BMR requirement may represent a general inclination toward hosting new affordable housing and creatively utilizing available subsidy streams to accomplish this goal. However, the same feature may also complicate the building process, if the units specified in the ordinance do not match the type of unit the affordable housing developer would construct. For example, a builder of moderate priced housing may have much less leeway than a builder of luxury units in covering the added costs of BMR units.

Variations in Requirements and Resources Shape Impacts of Ordinances

Consider a continuum of possible requirements. At the stringent extreme, the BMR requirement sets a high, non-negotiable percentage of units a for-sale project must set aside for sale at drastically reduced prices. Those set-aside units must be integrated into the existing project on-site, and no city-sponsored program exists to identify and

assist qualifying buyers. At the opposite, most flexible extreme would be an ordinance providing for in-lieu fees, off-site placement, partnerships with nonprofit builders, rentals to satisfy for-sale set-asides, public subsidy, and assistance identifying qualifying occupants.

In the first case, most builders will require economic conditions strong enough to permit deep cross-subsidies. In the current downturn-given the scarcity of capital-BMR-impacted projects pencil out much less frequently. In the second, more flexible regulatory scenario, the BMR requirement can more easily be adjusted to fit the realities of developer circumstance, market conditions on the ground, availability of financing and subsidy, and changing policy prerogatives. In some places, under requirements of this latter type, BMR portions of projects proceed while market-rate construction has all but shut down.

Shifting Patterns of Feasibility and Building in a Down Market

The mix of market rate and affordable development opportunities has shifted in the housing downturn. The credit crunch combined with the decrease in home prices has left many market rate builders no choice but to cancel or postpone projects. Some market rate builders are adjusting their pipeline for the expected cycle of market recover in the coming years by buying or continuing land options until development becomes feasible again. Others are responding to buyer price point sensitivity by adjusting product types and finishes.

Because the source of funding may include public subsidies, affordable housing builders sometimes can continue with new projects, although they too have faced delays and cancellations. In one Southern California master-planned project, the market-rate

building has been postponed, while the BMR portion, on land previously donated by the developer, is moving ahead.

Different Implications of For-Sale and Rental BMR Requirements

The weak housing market has emphasized concerns related to the tenure focus of BMR ordinances. Finding the right price-point for BMR ownership housing becomes challenging when market rate prices are dropping. A number of communities and builders report that market-rate homes had dropped in price to a point close to the price levels set for BMR for-sale homes. In the worst economies, revenue from subsidized rental housing may be more predictable, and thus less risky as an investment, compared to price-restricted for-sale product. The narrowing of the price gap between market rate and BMR homes reportedly has led some California cities (not only case-study city Santa Clara, but also Thousand Oaks and Tracy) to reconsider the necessity of their BMR ordinances (City of Tracy 2009, Prescott 2009).

Price Sensitivity for Moderate Priced and Affordable Home Builders

In the downturn, the marginal effect of BMR housing requirements may be most onerous for homebuilders least able to locate sustainable cross-subsidy from their market rate product, i.e., those specializing in moderate-priced, affordable homes. Among our respondents, affordable housing builders and those who specialize in the lower end of market-rate housing, are most likely to view BMR requirements as a factor in their company's loss of business in the current economy. Narrow profit margins for these builders leave little room for in-project subsidy targeting even lower income groups. This price sensitivity of BMR impacts suggests that building recovery could be slower in

jurisdictions with BMR requirements, because the price “break even” point for new construction would be higher.

Affordability Programs and BMR Requirements—A Changing Mix

A portion of BMR housing is built making use of various programs that subsidize affordable housing. These include low income housing tax credits (LIHTC), proceeds from statewide affordable housing propositions (e.g., Proposition 46 [\$2.1 billion, 2002], Proposition 1C [\$2.85 billion, 2006]), funds set aside under the redevelopment tax-increment financing mechanism, and other city subsidies. The availability of LIHTC funds has been greatly reduced by the recession, because of declining investment demand from the purchasers of the tax credits and the resulting fall in the dollar value of the tax credits. Remaining demand for tax-credit investment is concentrated in projects utilizing the higher-yield competitive nine-percent tax credits, required to be located within one-quarter mile of a transit stop, school, park, library, and other urban amenities. Such sites are scarce as it is, and the net result is that little of the affordable housing still being built is in settings with BMR requirements, according to the developers interviewed.

Partnerships

Many jurisdictions offer the opportunity for market rate-developers to partner with affordable housing developers, with the intent of assigning the development and management of affordable units to those with experience handling such projects. Larger developers of master-planned communities identified partnerships as a main means of compliance, while smaller developers are less likely to have the capacity for projects large enough to offer partnership possibilities. Because of other requirements of nonprofit project funding sources, the affordable portion of the partnership project is often

concentrated in buildings separate from the remainder of the project and is most often rental housing. The few projects in jurisdictions with BMR requirements that are continuing were of this type, with the building activity happening at the affordable end.

Jurisdiction Involvement

The outcome of a BMR ordinance depends in part on the jurisdiction's approach and degree of involvement. Jurisdictions may assist the process in several ways, including a) working flexibly with the builder to find the best housing location, type and income mix to comply with the ordinance, b) providing further subsidies for the affordable portion of the project, and c) providing assistance in selling or leasing the affordable product. For-profit developers positioning themselves for the recovery period are working with cities to adjust requirements going forward. For example, if the market price is now more moderate, the builder may try to negotiate a project with fewer or no BMR units, to improve project feasibility. Nonprofit builders that are attempting to continue providing product in the current economy are at times seeking further assistance from the local jurisdiction.

"Best Practices"—The Design and Implementation of BMR Ordinances

Market-rate and affordable housing builders hold varying perspectives on the design of BMR ordinances. Market-rate developers consider BMR policies to be most effective when they are transparent concerning substantive and procedural requirements. They most value jurisdictions having strong organization and expert staff dedicated to supporting administration of the BMR ordinance.

Examples of effective policies and jurisdictional climates identified by market-rate developers include:

- Cities such as Irvine and Anaheim that show political support for large projects.
- Ordinances that reflected an understanding of economics and market drivers. (For example, Fremont’s willingness to allow market price sales after 6 months if no BMR buyers are found).
- Santa Clara’s low, uniform ten-percent set-aside.

Market rate builders were critical of places offering less support and or administering the BMR requirement only at arm’s length. Examples of supportive program administration include: a) Santa Monica Housing Authority’s published list of prequalified tenants, enabling opening-day occupancy of BMR units; b) Neighborhood Housing Services in San Mateo providing broker-like services, mortgage and down-payment assistance, and less onerous resale restrictions; c) Fremont’s program identifying buyers; and d) Palo Alto’s staff dedicated to operations of the BMR process.

Affordable housing developers share the concerns of their market-rate colleagues, with respect to predictability and staff sophistication regarding project economics and feasibility. They emphasize the advantage of ordinances allowing flexibility in how BMR product is delivered. One nonprofit developer pointed out that if in-lieu fees and land donations approximate the actual cost of the avoided unit, the cost of the BMR requirement would be more predictable and would likely be incorporated into the price of the land at the outset of the project.

While recognizing the need to accommodate to the current economic climate, affordable-housing developers emphasized their concern with maintaining the intention of the ordinance to ensure affordable housing. Suggested approaches include transferring

the BMR parcel to the city or affordable housing builder as soon as possible; and adjusting qualifying income upward (e.g., changing target group from 80 percent of AMI to 100 or 120 percent). Furthermore, affordable housing respondents brought up the possibility of government going beyond the BMR structure by taking advantage of the stressed real estate market and proactively investing in land or units that could be used to provide affordable housing in future years. However, no jurisdictions have the money to fund this type of land-banking venture, nor is federal funding provided for this purpose.

Legal Complications Raise Questions on the Future of BMR Ordinances

Two seminal state appellate court decisions finalized during the course of this research could well change the trajectory of BMR practice in California. In *Building Industry Association of Central California v. City of Patterson*, the court ruled the city had failed to demonstrate a “reasonable relationship” between the impacts of the permit-applicant builder’s new market rate housing development and the exaction of in-lieu fees. (The requirement that proponents establish such a reasonable relationship between the means and ends of BMR regulations is often referred to as the “nexus” requirement.) The city had raised fees from \$734 per unit to nearly \$21,000 per unit and had sought to apply the increase retroactively to two residential projects already planned under a preexisting development agreement. The decision accentuates points made during our developer interviews: many builders view it as inherently inequitable to force new construction to bear a disproportionate share of BMR project finance. As of the time of this writing, a number of jurisdictions are reevaluating their BMR ordinances to ensure consistency with the *Patterson* decision. For example, the City of Fremont plans on postponing the update

of its in-lieu fee structure, so that a now-required nexus study can be undertaken after the housing market stabilizes.

The other case, *Palmer/Sixth Street Properties v. City of Los Angeles*, potentially imposes even greater limits on the power of local government to compel inclusion of BMR units in new projects. In a permit condition for a new, 350-unit project, the city required the developer (Palmer) to replace sixty units of lower-income rental housing which had been demolished several years earlier. The city would set the rental rates for these units and the developer would have to maintain those rates for up to thirty years. The developer protested, requesting a waiver of the requirement. The developer claimed the BMR units would reduce the amount it could borrow by \$10 million, making the entire project financially impossible. The city declined the waiver request and the developer sued. The court ruled against the city, basing its ruling on the state's Costa-Hawkins Act. A legislative victory for California's landlords in 1995, that Act imposed vacancy-decontrol provisions on all rent-control systems in the state. Under Costa-Hawkins residential landlords enjoy the exclusive right to establish initial rental rates for all new tenancies.

Costa-Hawkins excludes from its coverage rental units receiving some type of incentive or subsidy, but this was not the case in *Palmer*. In this case, the court concluded that the BMR pricing of the replacement units would deprive landlords of that right, since the city would set initial rents and increasing them would be prohibited for thirty years. Even more damaging for proponents of inclusionary requirements, the *Palmer* court determined that providing an in-lieu fee option for the developer did nothing to cure the fundamental conflict with state law. Denying the city's petition for

review, the California Supreme Court left the Palmer decision in place as published law. As a result, rental inclusionary practice in California faces an uncertain future legally. Rental development continues to offer key opportunities for expanding affordability, however, and it may fall to market-rate and nonprofit developers, perhaps working in league, to substantially increase supply in a now less regulated business environment.

These two key decisions-taking effect at the depth of the recession- further complicate our analysis. Not only is the economy limping along and perhaps headed for a “double dip,” jurisdictions must now adjust their laws and practices in light of a substantially changed legal environment.

Summary of Findings and Future Research Directions

Earlier research suggests that the impacts of a poor economy on jurisdictions with BMR requirements will depend on the details of the requirements and the flexibility with which they are implemented. Historically BMR requirements have not been shown to affect the amount of housing built but have been found to have some effects on price (raising the price at the upper end, lowering prices at the lower end) and on mix (shifting to a larger share of multifamily units). The strength of the economy has been shown to affect the overall amount of housing built, whether in a jurisdiction with BMR requirements or not. Effects reported by California jurisdictions and builders in the 2007 to 2009 housing crisis are consistent with these findings. Most builders report that it is the economy, not the jurisdiction’s requirements, that have led the company to stop building, but they indicate that reentering the market could be hindered by stringent BMR requirements.

Interviews with city officials and builders indicate several important additions to this general set of findings. First, in some communities where the BMR housing is for-sale housing, prices have dropped to levels close to the price set for affordable units. If no adjustment to price, equity gains, or qualification levels are made, these restrictions could slow recovery in these markets. Cities have begun to make short term adjustments, in an effort to move recently constructed product, and are considering longer-term adjustments to ordinances in light of current experience.

Second, during downturns affordable housing builders report heightened sensitivity to BMR restrictions. Such markets complicate affordable projects and add costs amidst reduced margins and subsidy flows. Third, the ease with which builders appear to cope with BMR requirements in a strong market may be more a function of high real estate values in California, and related cross-subsidy capacity, than savvy regulatory practice; in such market contexts, stringent BMR requirements may in fact limit new building and make entry of competing firms difficult. Remove the embedded advantages to both builder and regulator in overheated economies, and the need for circumspect practice and ordinance redesign may arise. As prices drop, high-end market advantages evaporate—if builders no longer reap a higher profit margin in affected communities, they may be less able to subsidize BMR units. Lower land prices in down markets may make new housing more affordable (if the builder is not trying to carry a loan based on the higher land prices), but in most jurisdictions this affordability shift does not reach the level sought by the BMR ordinance.

Fourth, in BMR jurisdictions where affordable housing is provided through rental projects, the affordable portion of the project has been very dependent on a mix of

resources, including tax credits, tax increment financing, and a variety of other city subsidies. The ability to continue to finance these projects will depend on how quickly low-income housing tax credits regain their appeal, how quickly local jurisdictions recover from fiscal stress, and how promptly new sources of funding, such as the American Recovery and Reinvestment Act dollars, provide added cushion for financing affordable housing projects.

More broadly, the results suggest that best practice recognizes and accommodates, rather than ignores, changed economic conditions. BMR works best when it proceeds as a partnership between the builder and the host city, with mutual understanding of real financial circumstances and evolving policy prerogatives.

Two new areas of research can shed further light on the interactions of economic conditions, building activity and below market rate requirements. First, all of this study's information on adjustments to BMR law and practices has been essentially anecdotal, based on reports from a limited number of respondents in our case study cities and developer interviews. A comprehensive survey of communities to identify the types of problems encountered and adjustments made would give a more complete picture of regulatory flexibility. A second area of research would be to expand econometric research of the type described by Knapp *et al* by adding systematic analysis of business-cycle effects. This would involve adding variables such as employment growth rate and unemployment levels to models already extant in the literature, and applying the results to simulations to bolster insights gained in that effort. The analysis examining sensitivity among jurisdictions to economic conditions could be undertaken with historic data. However, analysis of the impacts of the current downturn and prospective recovery will

not be practicable until a considerable period of time beyond the stabilization of construction markets.

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