I. EXECUTIVE SUMMARY

OVERALL FINDINGS

The Los Angeles Housing Department retained David Paul Rosen & Associates to provide technical guidance to City policy makers in their deliberation over the question of whether Inclusionary Housing (IH) would be appropriate as a part of an overall housing policy in Los Angeles. David Paul Rosen & Associates issued a report (Rosen Report) in September 2002, which contains findings that are offered as guidance for those policy makers.

A review of the Rosen Report indicates that its two most important assertions are unsupportable and that it cannot be relied upon as guidance in the debate over the appropriateness of IH in Los Angeles. The principal reasons for this are as follows:

1. Its implication that IH is not likely to affect housing production in Los Angeles is based merely on a visual examination of bar chart data from other jurisdictions rather than the sophisticated statistical analysis that would be required to adequately understand data that extends over several years of observations.

2. It omits any discussion of several critical aspects of how the real estate market and new housing development in Los Angeles would respond to the additional requirements of IH.

3. Its findings of feasibility for an IH program are based on pro forma financial analyses that incorporate faulty assumptions for the costs and revenues associated with new housing development in Los Angeles.

Each of these deficiencies is summarized below and described in more detail in separate sections of this review. Furthermore, a number of potential adverse effects of IH on the housing market in a mature built-out city such as Los Angeles are not disclosed. Compared to a Los Angeles housing market without IH, the imposition of IH in the City will result in the following impacts:

1. The value of existing properties as potential sites for new housing development will be reduced.

2. The ability of residential developers to compete with non-residential developers (e.g. developers of industrial space, office buildings, or parking lots) for building sites in the City will be significantly reduced.

3. Underutilized properties or properties with existing improvements will have to decline in value further or deteriorate more before it becomes economically rational for them to be converted into sites for new housing as property owners will continue to collect rent rather than sell the property to residential developers at a reduced cost.

4. Over the near, intermediate and long-term, fewer properties in Los Angeles will be converted to sites for new housing projects, often perpetuating blight.

5. Fewer new housing projects will be built and the total number of new housing units produced in Los Angeles will be lower.

6. The new housing units that are actually produced in Los Angeles will consist of a mix that is more polarized in terms of value and rental rate with fewer units in the middle value range, impacting the availability of workforce housing.

7. Purchase prices and rental rates of existing housing units in Los Angeles will increase more rapidly and those units presently priced in the affordable range (and not restricted by law to remain so) will more quickly rise above the affordable range when supply is constrained.

8. The lower total number of housing units being produced, the more rapid increase in value or rents of the existing housing stock, and the shift of the new market rate units being produced to a higher value range will impede Los Angeles' ability to meet its regional housing goals.

PRODUCTION OF NEW HOUSING

The Housing Department was particularly interested in the potential impact of IH on the production of housing. The Rosen Report frames this question in terms of whether a visual examination of bar graphs representing total housing production in various jurisdictions over a 20-year time period reveals a decline in housing production after the imposition of IH. The bar graphs are also visually inspected to determine if any correlation can be detected between housing production and several measurable economic indicators.

The Rosen Report found no correlation between the level of housing production and the imposition of IH in 14 jurisdictions. The Rosen Report did find a correlation between two economic indicators (employment and housing prices). However, the presentation of the housing production data in the Rosen Report was not able to demonstrate any correlation between interest rates and housing production.

The presentation of the Rosen Report's findings leaves the impression that housing production is not adversely affected by the imposition of IH. This is both an unsupportable conclusion and incorrect because of the following:

1. Any meaningful investigation of the factors affecting something as complex as housing production in multiple jurisdictions over a 20-year time frame would require the use of complex and sophisticated multivariate time-series analysis.

2. What is characterized as an "analysis" in the Rosen Report is merely a superficial bar-chart tabulation of housing production figures for individual jurisdictions

coupled with the "eyeballing" of their relationship to other specified annual data or events, the most critical of which is ambiguously defined.

3. The Rosen Report's admission that its data presentation does not even demonstrate the well-documented relationship between interest rates and housing production means that any other conclusions based on that data presentation are extremely suspect at best and most likely invalid.

In the absence of the ability, financial resources or will to perform the necessary sophisticated multivariate time-series analysis, the question of whether IH is likely to have an impact on housing production must be addressed differently and in a way that is more meaningful to public policy makers.

It would be of more use to public policy makers if the question were framed as follows:

> ***Would the response of property markets to the imposition of IH in a jurisdiction be likely to result in less total new housing being developed in any year than if an IH program were not in place?***

The answer to this question is dependent on a number of factors. However, an absolutely critical factor is whether a jurisdiction that imposes IH is one that is essentially fully built-out. In a jurisdiction such as Los Angeles (which is a mature and essentially fully built-out city), it is a fact that virtually all of the new housing development in the future will occur on land that is already in some other use. If IH is imposed in such a jurisdiction without incentives that fully offset its financial burden, new housing developers will be less able to pay prices for new project sites that exceed the value of those sites in their existing uses or compete for sites with developers of other uses not subject to IH.

As a result of this reduced ability on the part of housing developers to compete for sites, fewer sites will be sold to residential developers, fewer new housing projects will be developed and fewer total new housing units will be produced than would be the case without the presence of IH.

OTHER CRITICAL ISSUES

It is necessary for public policy makers to be aware of and to understand several additional important issues, their impacts on the real estate market, and how new housing development will react to the imposition of IH in a jurisdiction. The following are among the critical issues related to IH that are often overlooked in the debate:

1. With lower total new housing production, rents and prices for the entire market-rate housing stock will increase to a level higher than would prevail without IH.

2. The new housing that is produced will be more polarized at the upper and lower ends of the rent and price spectrum.

3. Deteriorated housing and other marginal land uses (e.g. retail strip centers, industrial buildings, parking lots, etc.) will persist for a longer time, increasing the likelihood of unsightly blight in a jurisdiction with IH because those properties will continue to be more valuable in the existing uses than as sites for new housing development.

4. Because of the City of Los Angeles' vast size and the variety of development issues among its numerous neighborhoods, a single citywide inclusionary policy that does not consider this diversity will not be effective and is not feasible.

More Rapidly Increasing Housing Prices and Rents

Unless an IH program has significant incentives that offset the financial burden of compliance and exempts from IH requirements certain types of residential development for which these incentives are infeasible, the total amount of new housing built in a jurisdiction will be less than it otherwise would be as housing developers become uncompetitive in bidding for development sites. With a smaller amount of new housing developed than would be the case without IH and with a demand for housing that is constant or growing, the response in the housing market will be for rents and prices for units not set aside as affordable to rise more quickly and to a higher level than would be the case without IH.

Viewed another way, unless it is somehow possible to limit or reduce demand for housing in a jurisdiction at the same time IH is limiting the total amount of housing developed, rents and prices for market rate units will be higher than without IH.

Polarization of New Housing Produced

In practice, those developers of new housing who are able to acquire sites for new projects in jurisdictions with IH, will be faced with a decision as to what type of market rate units in each project should be eliminated to make room for the required number of affordable units. The basic economics of housing development will cause developers to eliminate market rate units with lower rents or prices and replace them with the IH units.

The clear result of this will be for the total number of new housing units produced to become more polarized at the upper and lower levels of the rent and price spectrum. This is because developers who are required to build a certain number of IH units in a project will substitute them for units that otherwise would have been in lower or middle portion of the range for market rate units. A higher proportion of the market rate units will be in the high rent and price range.

The adverse impact of this will fall most heavily on households that rely on units with rents or prices at the lower to middle range of the market and which do not qualify to occupy the IH units because of their income level. They will find that there are fewer units being produced for them than would be the case without IH.

Greater Deterioration of Existing Properties

Unless incentive packages are provided that fully offset the economic burden of complying with IH, new housing developers will necessarily have to pay less for sites for their projects than they could without IH. This means that someone selling a property to a developer as a site for a new housing project would receive a lower price than would be the case without IH.

With properties worth less because of IH requirements, any properties with existing uses will have to decline further in value before it would be economically rational for the owners to sell them to developers as sites for new housing projects. Such a further decline in value before a property is sold for redevelopment would be accompanied by increased physical deterioration or greater obsolescence. Both of these tendencies are of very significant public policy interest. Furthermore, this effect will be particularly pronounced in a city such as Los Angeles, which is essentially fully built out.

One Policy Does Not Fit All

From the standpoint of the range of neighborhoods and real estate sub-markets, Los Angeles is perhaps the most diverse city in the country. As such, it has neighborhoods which vary enormously with respect to existing physical, economic, social and political issues. Those factors which differ so much across the different neighborhoods have a very large impact on both the local need for affordable housing and the practicality of any package of incentives or offsets that would be required to assure new housing is not stifled. Any serious consideration of an IH program in Los Angeles would need to clearly identify the different neighborhoods in the City and tailor its parameters to each.

FEASIBILITY OF INCLUSIONARY HOUSING

The Rosen Report asserts that a number of new housing development scenarios in Los Angeles will generally remain feasible if IH is imposed. It defines feasibility as the residual land value for new housing development sites falling within a range of observed market values. Ten different prototype new housing developments were analyzed for three different ranges of land market values and combined with up to four different IH "incentive" packages. The Rosen Report implies that the residual land value (RLV) will fall within an observed range of market land values for 58 of 166 different scenarios of prototypes and incentive packages. The Report also implies that RLV for projects with IH and various incentive packages (including no incentives) will decrease compared to the market rate RLV in 74 out of the 96 pro formas that were created, increase in 20 out of the 96 pro formas, and remain approximately the same in 2 out of the 96 pro formas.

These findings are unsupportable and invalid because the pro forma financial analyses on which they depend are fatally flawed. Specifically, the Rosen Report's financial analyses base their findings on:

1. Ranges of land market value intended to define feasibility which are so broad that they mask the fact that new housing projects would become infeasible in many areas of the City where they would otherwise be feasible without IH,

2. Development costs for prototype projects without IH that are significantly understated and not consistent with the actual development costs in Los Angeles,

3. Rents for finished rental housing products which are inconsistent with market values, along with sales prices and rents for the affordable units that may be overstated, and

4. Extremely unrealistic assumptions as to the ability (physical, financial and political) to actually utilize IH incentive packages designed to offset the economic burden of complying with IH requirements.

Each of these deficiencies has the effect of overstating the derived residual land value or understating the sales price that is required to make the project financially feasible for new housing development after the implementation of IH in Los Angeles and creates the false impression that many types of new housing development would remain feasible. In fact, the residual land values for the new housing development prototypes analyzed will be much lower than the Rosen Report suggests and their financial feasibility in the Los Angeles market will be significantly degraded.