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September 25, 2018

Chair Georgette Gomez
Smart Growth and Land Use Committee
City Administration Building
202 "C" Street, 10th Floor
San Diego, CA 92101

RE: Recommendations for Reforming Inclusionary Housing Policy

Dear Chair Georgette Gomez:

On behalf of Circulate San Diego, whose mission is to create excellent mobility choices and vibrant, healthy neighborhoods, I am writing with recommendations for how the City of San Diego can reform its inclusionary housing policy.

Circulate San Diego is a longstanding supporter of expanding the supply of both market-rate and deed-restricted affordable homes. We believe that policy should promote the construction of both types of homes, in a manner that does not unreasonably burden the other.

Inclusionary housing is a widely used tool to promote affordability and integration. Paired with programs like density bonuses to offset added costs, inclusionary housing can achieve the dual goals of building more market-rate, and more affordable homes.

Additional housing construction, especially near transit, will help more San Diegans to live and travel more affordably, and with a lower greenhouse gas footprint. Circulate believes that housing policy can be achieved with the win-win-win goals of affordability, economic development, and addressing climate change.[1] A properly structured inclusionary housing policy can help advance all of these purposes.

1. **Inclusionary Housing policies often balance trade-offs, but reform can offer opportunities to improve policy for both market-rate developers and affordable housing advocates.**

[1] Circulate San Diego, Letter: Recommendations for Win-Win-Win Approaches to Housing Affordability in the City of San Diego (January 26, 2017), available at http://www.circulatesd.org/policy_letter_recommendations_for_win_win_win_approaches_to_housing_affordability_in_the_city_of_san_diego.

While inclusionary housing is a worthy goal and policy tool, it can create added costs to new market-rate construction. If an inclusionary percentage is set too high, it may result in fewer units being produced overall, or no units being produced whatsoever. Similarly, if an inclusionary policy is set sufficiently low, it might result in fewer affordable units produced than projects could afford to support.

To achieve these dual goals of producing market-rate homes, and of producing deed-restricted affordable homes, an inclusionary policy can apply different obligations to different types of projects, or to projects in different types of neighborhoods.

An inclusionary policy can be designed to increase or make mandatory the affordable obligations on projects that can afford them. Simultaneously, an inclusionary policy could require lower or even no affordable obligations for projects that cannot afford them, or that already serve a below-market demand. The reform to San Diego's inclusionary policy has the potential to provide a "win" for at least some segments of the market-rate development sector, while simultaneously increasing the production of resources for affordable homes.

Below are some recommendations for how the City of San Diego should develop and adopt an update to its inclusionary housing policy, to achieve the dual goals of maximizing production for both market-rate and affordable homes.

2. **Updates to inclusionary policy should not undermine current incentives to produce homes for low income families through San Diego's enhanced density bonus program.**

The City of San Diego has an enhanced version of California State Density Bonus, called the "Affordable Housing Regulations" in the municipal code. Research from Circulate San Diego shows that the bonus program is driving construction of both affordable and market-rate homes.[2]

San Diego's bonus program currently creates meaningful financial incentives for developers to choose to set aside up to 15 percent of their units for families making 50 percent or less of Area Median Income (AMI). The City's current inclusionary policy only requires 10 percent of units to be affordable, at a less deeply subsidized rate of 60 percent of AMI. In short, San Diego's inclusionary policy generates less affordability than the bonus program creates through effective incentives.

Any update to the Inclusionary Policy should be carefully calculated not to reduce the current incentives to build deeply subsidized homes while simultaneously producing more market-rate homes than would be otherwise permitted.

3. **Inclusionary obligations must comply with California Density Bonus Law.**

California law requires that any local inclusionary policy must not undermine State Density Bonus Law. In 2013, the California Court of Appeals in *Latinos Unidos* determined that local governments must

[2] Circulate San Diego, Early Wil for Affordable Homes Bonus Program (October 18, 2017), available at http://www.circulatesd.org/ahbpreport.

count on-site inclusionary units in determining a project's eligibility for California's state density bonuses.[3]

To ensure the continued success of San Diego's enhanced density bonus program, the City should follow the logic of *Latinos Unidos* and allow on-site inclusionary units to count toward the local enhanced density bonus. This will mean that developments building as much as 15 percent inclusionary will continue to receive the locally enhanced density bonus benefits.

Similarly, San Diego should also exempt density bonus units from the calculation of a development's inclusionary obligations. Instead, the inclusionary obligation should arise from the base density, not the total number of units that are built using a state or locally enhanced density bonus.

4. **Financial analyses should be performed to ensure that inclusionary obligations maximize affordable production, without making needed market-rate construction financially infeasible.**

The correct percentage of new units to be set aside for low income families should be determined by financial analyses, not through an arbitrary percentage. We understand that the San Diego Housing Commission has already commissioned some financial analyses.[4] San Diego should ensure that these calculations are not limited to only a "nexus analysis" to determine a maximum level of inclusionary that may be legally supported. The analyses should also be prepared to assist decisionmakers to determine what levels of inclusionary can be financially supported by market-rate developments.

The financial analyses should reflect the type of development the City has anticipated in its Climate Action Plan and City of Villages strategy. Housing production should generally assume infill production, with a smaller scale and more expensive construction type than more historic suburban development patterns.

If the City of San Diego proposed adopting an inclusionary requirement above 15 percent, such an analysis would not just be wise policy, but it would be legally required to satisfy the newly amended California Government Code Section 65850, as explained below.

5. **Different neighborhoods and product types may require different inclusionary obligations.**

Current inclusionary policy in San Diego requires every new development to either build 10 percent of their units affordable, or pay a flat fee per square foot. Those requirements are uniform across the City, regardless of product type.

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[3] *Latinos Unidos Del Valle De Napa Y Solano v. County of Napa*, No. A135094 (First District, July 11, 2013).

[4] San Diego Housing Commission, Presentation to the Smart Growth and Land Use Committee (September 19, 2018), available at https://onbase.sandiego.gov/OnBaseAgendaOnline/Documents/ViewDocument/SG_LU%20Sep%2019%20_%20SDHC%20Presentation.Print.ppt.pdf?meetingId=1325&documentType=Agenda&itemId=28488&publishId=115112&isSection=false.

A recent study from the New York University Furman Center demonstrated that even within the same city, different inclusionary requirements can be appropriate for different neighborhoods.[5] The Furman Center financial analyses showed that in New York City, certain high value neighborhoods could shoulder larger inclusionary obligations because of the high profitability of developments there. Conversely, other neighborhoods could only shoulder lower inclusionary requirements, because projects in those locations have relatively smaller profit margins. In neighborhoods where the inclusionary requirements were set too high for the market to support, the inclusionary policies would prevent construction of any new homes.

Dynamic inclusionary requirements have recently been adopted in the City of Los Angeles.[6] There, an inclusionary in-lieu fee is higher in higher value neighborhoods, and lower in neighborhoods with lower land values.

San Diego could also set an inclusionary percentage differently between different neighborhoods, community planning areas, or council districts. Alternatively, the inclusionary requirement could be even more dynamic, requiring a higher inclusionary obligation for buildings with higher-end units, regardless of where they were located. That dynamic percentage could be derived from starting rental rates, or a formula using the appraised land value, divided by the total number of units.

Similarly, San Diego might consider different inclusionary requirements for different product types. Larger projects often already build affordable on-site, because of economies of scale and the availability of tax credits. Those projects might be subject to higher or mandatory on-site obligations, while allowing smaller projects to have a lower obligation, or to pay an in-lieu fee.

6. **While in-lieu fees should be maintained in many circumstances, they should not be artificially less than the cost of building off-site affordable homes.**

The current inclusionary policy for the City of San Diego is structured so that many developments find it generally less expensive to pay an in-lieu fee than to build the on-site affordable units. The policy should be restructured so that the in-lieu fee is more closely tied to the cost of building an average off-site affordable home, accounting for all of the other leverage available in state and federal programs like the

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[5] Josiah Madar, Inclusionary Housing Policy in New York City: Assessing New Opportunities, Constraints, and Trade-offs. NYU Furman Center (March 26, 2015), available at http://furmancenter.org/files/NYUFurmanCenter_InclusionaryZoningNYC_March2015.pdf.

[6] Dakota Smith, "L.A. City Council approves development fee to raise money for affordable housing," Los Angeles Times, December 13, 2017, available at http://www.latimes.com/local/lanow/la-me-ln-linkage-fee-city-council-20171212-htmlstory.html. The City of Los Angeles also hosts a useful page explaining their housing fee program, including maps for which neighborhoods have different fee levels. City of Los Angeles, Affordable Housing Linkage Fee Background Web Page, available at https://hcidla.lacity.org/affordable-housing-linkage-fee-background, last visited September 14, 2018.

Low Income Housing Tax Credits and SB 1 funds. This will reduce an incentive to “just pay the fee,” and to encourage more developments to combat segregation and build mixed-income communities.

Inclusionary housing’s goal of economic integration is important and should be advanced. Nonetheless, affordable housing has a competing goal to serve as many families as possible with safe and affordable homes. A properly structured in-lieu fee should ensure that when developers “just pay the fee,” they will contribute sufficient revenues to clearly and convincingly house more families off-site.

7. **In-lieu fees should be determined through clear, consistent, and ministerial processes.**

The current in-lieu fee for San Diego is determined though an annual formula calculation, based on a variety of complex inputs. The fee is adjusted year-to-year, based on a combination of that analysis, advice from consultants, Housing Commission recommendations, and council votes. The result is an obscure process that allows the fee to be shifted as much by political considerations as market conditions.

There are numerous principled ways to calculate an in-lieu fee, to achieve a variety of defensible policy goals. Regardless of how the fee is initially determined, it should be calculated in a transparent and predictable way, free from annual political decisions. If the fee is to be updated periodically, it should be tied strictly to an objective measure like a construction cost index, and updated ministerially.

8. **Inclusionary obligations must be consistent with the newly amended California Government Code Section 65850.**

The California legislature recently adopted AB 1505, which amended California Government Code Section 65850 to allow greater latitude for local governments to adopt inclusionary policies. AB 1505 also limits the authority of jurisdictions to adopt inclusionary policies above 15 percent, if they have built less than 75 percent of their above-moderate homes, as called for in their Regional Housing Needs Allocations. San Diego has built slightly less than 75 percent,[7] and is thus subject to review by the State.

If any policy adopted by the City of San Diego called for greater than 15 percent inclusionary, then San Diego would also need to produce an economic analysis to rebut the presumption that the policy would undermine market-rate housing construction. As suggested above, this is another independent reason for San Diego to commission financial analyses, in order to inform the inclusionary requirements it may adopt.

[7] California Department of Housing and Community Development, 5th Cycle Annual Progress Report Permit Summary, available at http://www.hcd.ca.gov/community-development/housing-element/docs/Annual_Progress_Report_Permit_Summary.xls (showing above-market construction at 74.5 percent of Regional Housing Needs Allocation), last visited September 10, 2018.

9. Conclusion.

Circulate San Diego is committed to making our region a more affordable place to live, work, and play. We believe that more market-rate and affordable homes, especially near transit, will help achieve these goals.

It is our hope that these recommendations help inform how San Diego crafts updates to its inclusionary housing policy.

Sincerely,

Colin Parent
Executive Director and General Counsel

Cc: Mayor Kevin Faulconer
Members of the City Council of San Diego