THE GENTRIFICATION PLAN FOR METRO PORTLAND

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The past year has been a tumultuous one for housing policy in the Portland metropolitan area. Our regional government, Metro, has been engaged in determining whether the Urban Growth Boundary should be expanded. Apartment rents and home prices in the region have reached new historic highs, even after accounting for the 30 percent decline in prices following the Great Recession. Developers have responded with a flurry of apartment construction in central neighborhoods in Portland, leading to a strong reaction by neighborhood organizations and activists. Portland Mayor Charlie Hales has proposed a tax on demolition permits, and city commissioner Dan Saltzman has proposed a tax on office development to subsidize affordable housing construction. With this much activity and proposals in play it's worth some time to discuss the fundamentals of the economics of housing and our policies to promote affordable housing.

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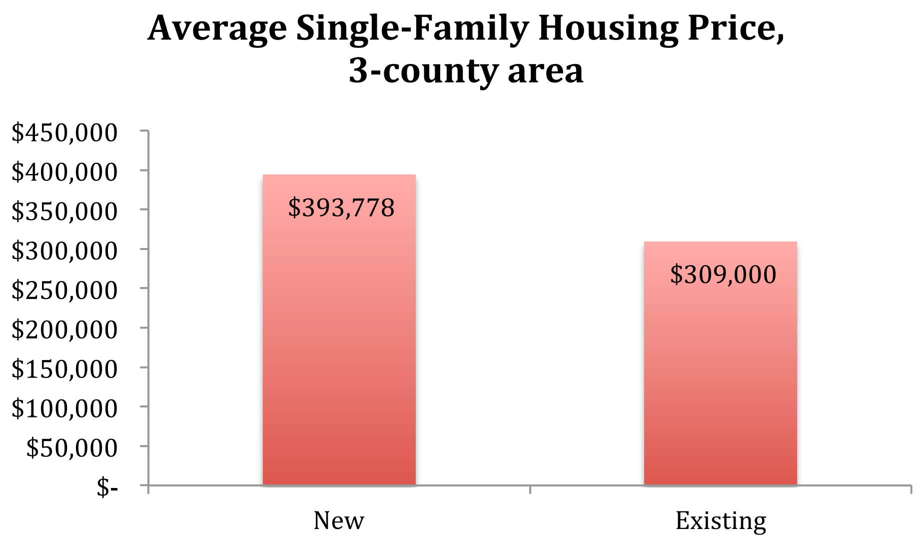
COST OF NEW VS. EXISTING HOUSING

A first principle of housing policy is the idea that existing housing is almost always more affordable than new housing. Using numbers calculated by our Master degree student, Clancy Terry, in the last issue of the *Quarterly Report*, we find that the average new single family home sold for $85,000 more than the average existing single family home, or about 25 percent additional cost (Terry, 2015a). There are two main reasons. First, as incomes have risen over the past 100 years, houses have become larger and contain more amenities than in the past. Features like garage door openers, air conditioners, and built-in trash compactors didn't exist in the 1920s, yet today's new homebuyer demands them. Second, housing structures depreciate over time—roughly at a rate of 2 percent per year. It's simply not possible to build a new house with a mossy roof, a cracked sidewalk, or worn out carpets.



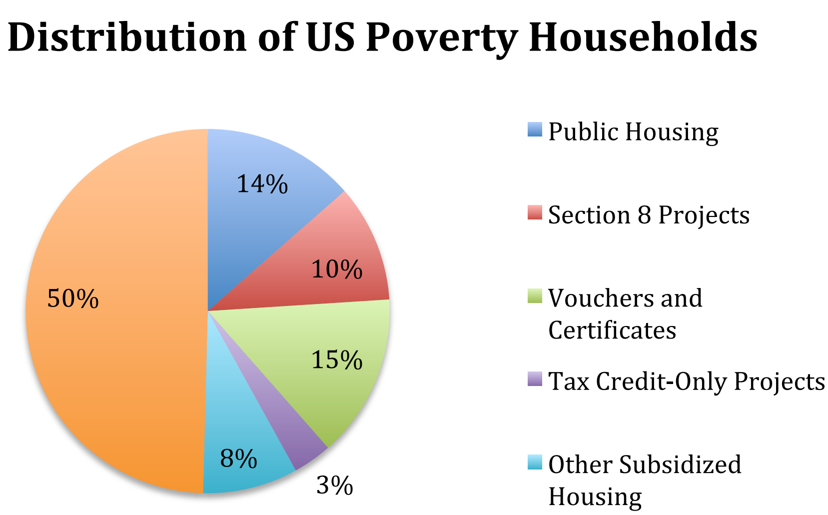
The implication for housing policy is that today's affordable housing is a vintage product that is made available as the result of new housing construction adding to total supply. Households with higher than median incomes can afford the new construction, and as they move into those new homes, older homes are freed up for less affluent households. So, just as households of modest means shop for affordable transportation on 82nd Avenue or look for affordable furniture on Craigslist, they look for affordable housing from the stock of existing housing being vacated by more affluent households. And if we want more affordable housing (meaning more low cost housing), we need to encourage rapid new housing construction, even if the new housing appears to be out of the financial reach of lower income households.

Unfortunately, this essential lesson of housing economics is lost on many of today's affordable housing advocates, who continue to lobby for new construction of "affordable housing." However classified, new homes are costly and cannot be built at lower cost without sacrificing quality, compliance with building standards, dura-

bility, or steep subsidies. As a result, new apartments cost much more per square foot than the average apartment in the region. To give a well-known example, Bud Clark Commons, a 130 studio apartment complex built by the public agency Home Forward in 2011 in downtown Portland, cost over $300,000 per studio apartment, much more than the average single family home price at that time (Meinhold, 2013). Public housing authorities would serve their clients better by issuing housing vouchers that would allow their clients to shop for existing homes and apartments closer to their preferred location.

MARKET RENTS MATTER

A second overlooked conclusion from the housing policy literature is that most low-income households pay market rents. We can compare the 9.6 million households below the poverty line in the United States to the 1.3 million households living in public housing, 1.0 million living in Section 8 projects, 1.4 million using housing vouchers, 300,000 in low-income tax credit housing, and 800,000 living in other subsidized housing programs (US Department of Housing and Urban Development, 2015, US Census Bureau, 2015). That leaves 4.8 million households (or 50 percent of the households in poverty) renting at market prices.



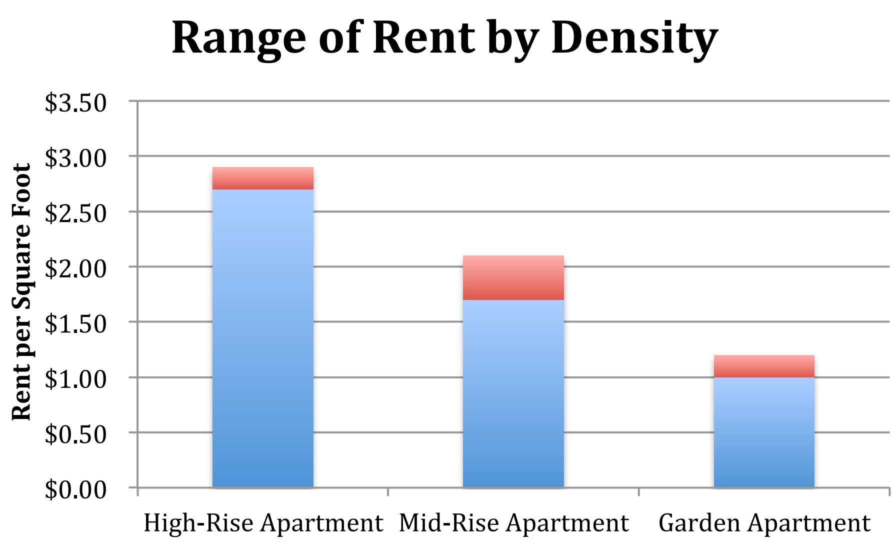
Note that many housing projects receive help from multiple subsidy programs, but the compilation by HUD accounts for that, which is why one category is called "tax credit-only." Also, not every subsidized housing tenant is categorized as below the poverty line, so the percentage of poverty households living at market rents is higher than the 50 percent estimated by these numbers.

The conclusion from this data is that we must be sensitive to trends in market conditions if we want to protect low-income households from unreasonable housing

cost burdens. Affordable housing advocates often decry the lack of government support for subsidized projects, but the reality is that inherently high cost of housing necessitates the rationing of subsidy budgets. Thus, not everyone who qualifies for housing assistance receives a subsidized unit, only the first in line. Consequently, subsidization of housing projects is a policy that is inherently inequitable. On the other hand, reducing the market price of housing by promoting (or not impeding) more production creates a tremendous benefit to all low-income households given the size of housing costs in the household budget of low income households.

HIGH DENSITY MEANS HIGH COST

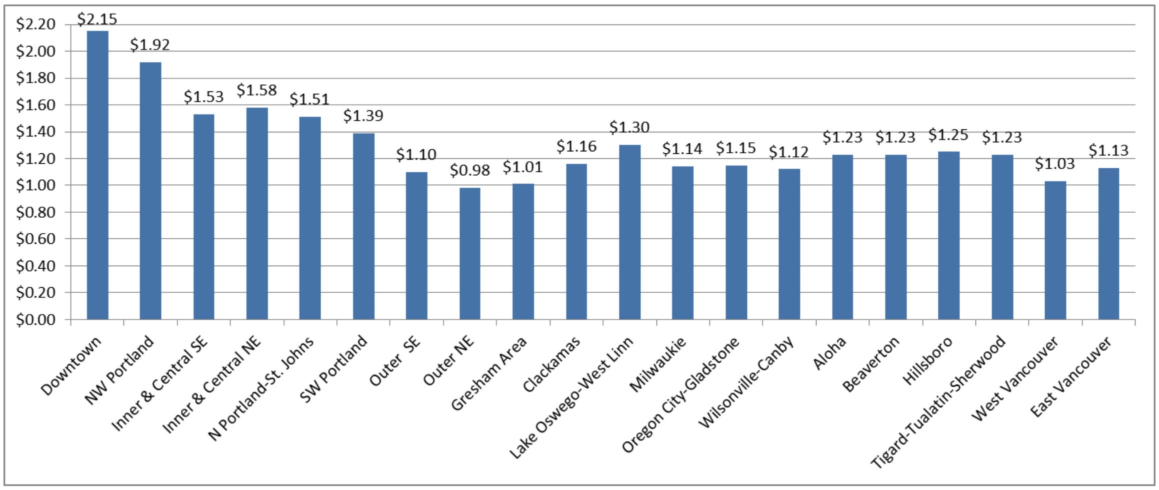
An important conclusion from the urban economics and the housing economics literature is that high density development is more costly to build and provides fewer consumer amenities. It only occurs naturally when site values are very high, and household incomes are high enough to permit the product to be marketed. We can see this from the table of apartment rents below that was generated from a study the Center undertook for the Holland Partner Group in 2014.



As part of that study, we collected pro formas from a large number of recently constructed housing projects in the Portland metropolitan area. The blue bars represent the low end of the range and the red bars represent the high end of the ranges. We separated he projects according to whether they were garden apartments (typically two-story wood construction), mid-rise apartments (typically four stories of wood construction over a concrete podium), or high-rise apartments (typically steel and concrete construction, greater than five stories). Then, we calculated the average apartment rent on a dollar per square foot basis. The projects that were least expensive to rent (per square foot per month) were the low-density garden apartments and the most expensive were the high rise apartments.

Apartment rents in most metropolitan areas are greatest at the center of that metropolitan area. And as you would expect, the high-rise construction projects are only found in Portland's Central City, which has the highest rents in the region. The mid-rise apartments were built largely within three miles of downtown, and the low-rise apartments were mostly built outside that perimeter.

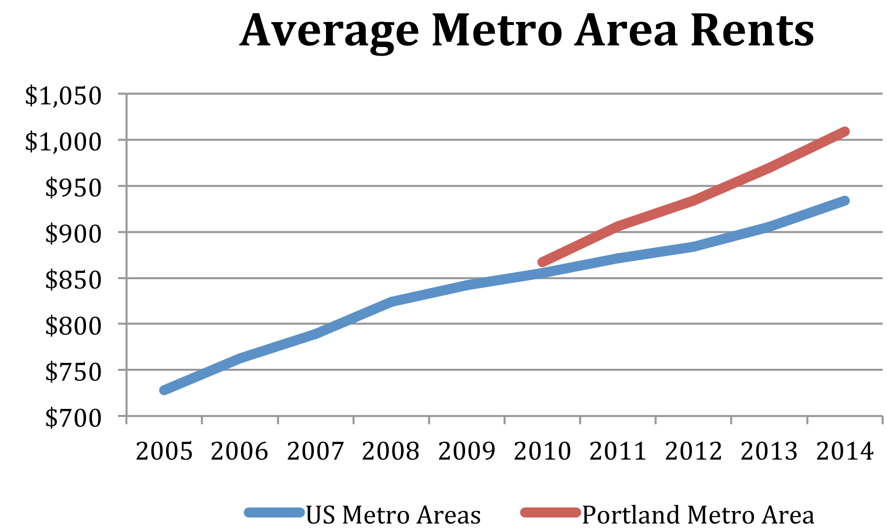
This pattern of apartment rents and locations can also be found in the work that Clancy Terry produced in this issue of the *Quarterly Report* (Terry, 2015b).



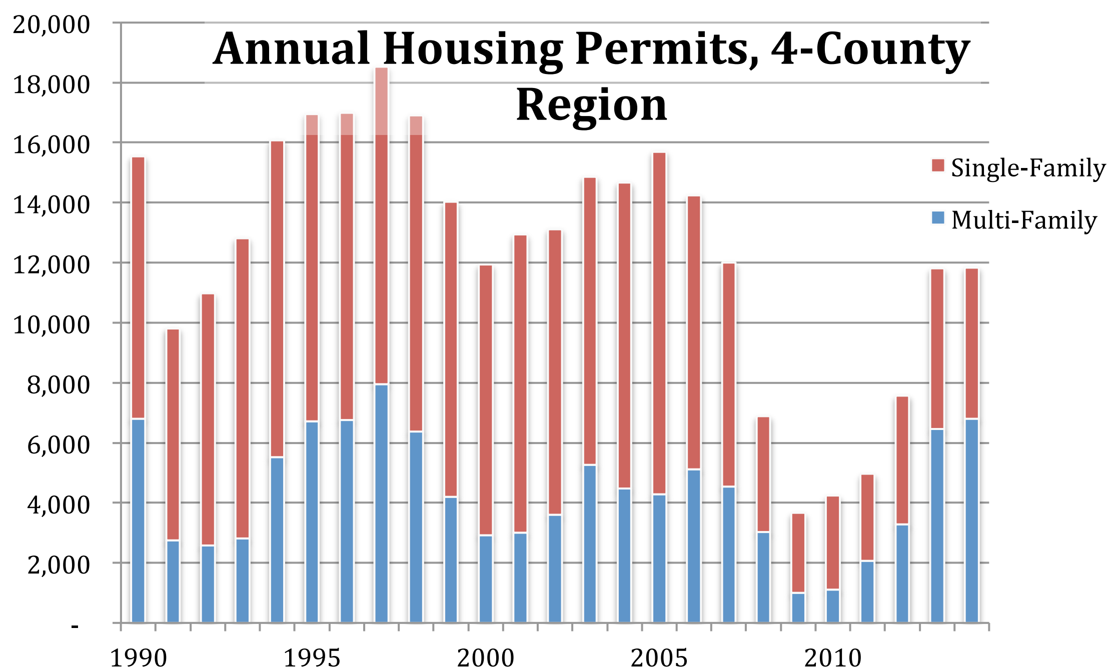
In the chart, districts are arrayed from the most central locations on the left and the most remote locations on the right. The information in the two charts isn't directly comparable, however, since the project pro forma rents reflect the price of new units and the average rent data reflect all apartments, including older ones. In any case, these are the markets that developers are building into, and it takes $2.00 per square foot average rents for existing apartments in downtown Portland to justify $2.70 rents for new high rise construction. Conversely, it's hard to imagine anything besides garden apartments being built in Outer Southeast Portland or Outer Northeast Portland when average rents are $1.09 and $0.93, respectively. More on that later.

PORTLAND'S ANEMIC HOUSING PRODUCTION

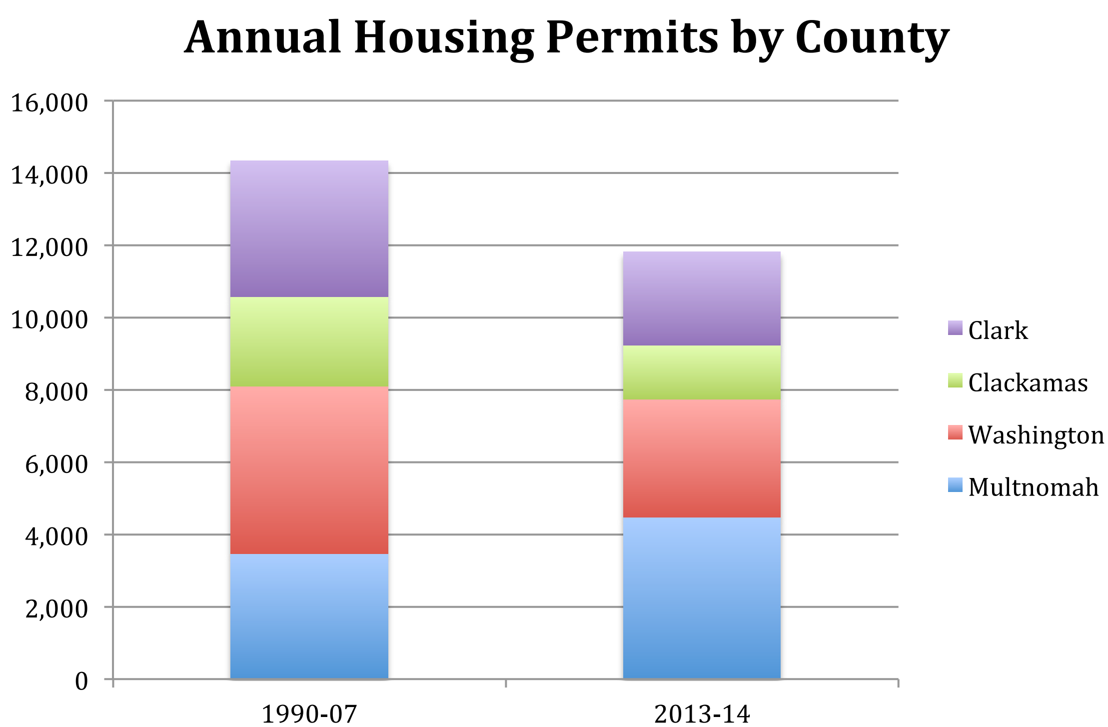
Given these observations, it seems critical for the Portland metropolitan area to boost housing production to moderate the trend in apartment rents and home prices. Rents in the Portland metro area, which have lagged national averages historically, now exceed those averages. Data prior to 2010 for the Portland metro aren't available, but statewide numbers suggest that Portland apartment rents were much lower than national averages prior to 2009.



At the same time, housing production in the region has fallen compared to the levels during the housing boom. We are producing 20 percent fewer units in the last two years compared to the period from 1990 to 2007. This is very surprising, given that home prices have now fully recovered to their peak prior to the housing bust and apartment rents have reached their highest levels ever.



Looking more deeply at these numbers, we find that multi-family construction has returned to normal levels, with a large shift from suburban construction to construction in the City of Portland. However, there has been a large decline in single family construction in all the counties in the metropolitan area. This could be a change in tastes. Additionally, household incomes and mortgage credit access declined sufficiently during the recession to shift demand away from the single-family market. However, in the Portland region this likely reflects the fact that building sites are in short supply due to minimum density regulations and regional supply constraints. That lack of new suburban housing production has led many of the new residents wanting single-family living to seek housing in the gentrifying neighborhoods of Southeast and Northeast Portland.



The two shifts from single-family to multi-family construction and the shift from suburban to central city construction create negative consequences for housing affordability. Apartments in the central city tend to be higher density, and higher density construction tends to be more expensive. And given that the aggregate number of housing units produced is reduced, less supply implies higher housing costs.

INCLUSIONARY ZONING, LINKAGE FEES, AND HOUSING SET ASIDES

Given these trends and the economics of affordable housing, the efforts of Portland's City Council seem woefully inadequate, if not misguided. As mentioned previously, the Mayor has proposed a tax on demolition, which is a necessary precursor to redevelopment. This policy could have significant impacts given Metro's reliance on redevelopment and infill for 90 percent of the City of Portland's housing capacity in the next 20 years. Others on the city council have lobbied for a lifting of the statewide ban on inclusionary zoning and the imposition of a commercial office linkage fee for affordable housing. Finally, the city council has raised the subsidized housing set aside in urban renewal areas from 30 percent to 50 percent.

Inclusionary zoning and commercial office linkage fees should be seen as development taxes geared to raise funds (or produce units) for subsidized housing. In the case of inclusionary zoning, developers of a particular number of units or more are expected to provide a percentage of housing units at a particular rent level for a particular period of time. In that formulation, there are several unknowns: (1) the unit threshold, (2) the percentage of below market units, (3) the amount of subsidization per unit, and (4) the period of time of subsidization. Given these four variables, inclusionary zoning ordinances can be written very strictly and present an onerous burden on development, or they can be written in a gentle way and impose a small burden. And in some jurisdictions, the developer is allowed to pay money into a subsidized housing fund, rather than build below market units directly.

However, regardless of the intent, an inclusionary zoning requirement is a burden on development and should be seen as a development tax. Developers will take a loss on the subsidized units for the "privilege" of building market rate units. As such, it's a very peculiar and harmful tax.

Because high apartment rents result in part from lack of supply, it seems strange to tax housing supply which, if effective, would only drive rents higher. This counter-productive feature of inclusionary zoning has led some housing market analysts to interpret its intent as "exclusionary zoning," due to its negative impact on housing production. Most jurisdictions implementing inclusionary zoning are higher income (e.g., Montgomery County, Maryland and Boulder, Colorado), and this critique suggests that their unstated goal is to prevent growth, not build subsidized housing.

Commercial office linkage fees represent a similar strategy. In this case, fees are levied on the construction of commercial office buildings to pay for subsidized housing projects. The conception of the fee as a development tax is clearer in this example. The few jurisdictions that implement this fee represent very strong office markets such as San Francisco. Local residents perceive new office development driving up apartment rents, and they may get support from existing property owners who want less competition. However, to generate significant amounts of revenue, the

linkage fee will likely reduce economic activity within the city, which would seem counter-productive from the point of view of helping residents achieve the income to pay housing costs.

Finally, both of these two policies—inclusionary zoning and linkage fees—are usually associated with the construction of new subsidized housing units, which limits the number of incremental units produced. Cities would be better off with a policy that liberates additional development sites and, if any income redistribution is warranted, it would be better to offer portable vouchers to support rental payments on any unit, rather than particular housing units. This would stimulate new production in the aggregate and free up older units.

Fascination with subsidized housing units also limits the effectiveness of the City of Portland's urban renewal policy. Urban renewal is designed for blighted city neighborhoods to receive new infrastructure and private economic development. Historically, urban renewal has been used to develop road, transit, and sewer infrastructure, allowing neighborhoods like Portland's Downtown, Pearl District, South Waterfront, and Airport Way to become economic engines for the region. The city makes public infrastructure investments and the additional property tax on the new private investment pays for the infrastructure.

Unfortunately, the Portland City Council in 2006 imposed a requirement that 30 percent of the public investment in an urban renewal district has to be set aside for subsidized housing, which neither attracts private investment nor pays property tax. Earlier this year, the Council raised this percentage to 50 percent. While this policy may force some subsidized housing to be built, the potential for catalytic public investments, such as a new road, a new bridge, a new transit line, or repairing a decaying eyesore property is made less likely. And because the subsidized housing pays no property tax, it generates no incremental revenue to finance public improvements.

METRO'S BET ON HIGH DENSITY

In this environment of policy turmoil, Metro has finished a multi-year process to decide whether to expand the Portland Metro Urban Growth Boundary (UGB). Earlier this month, the Metro council endorsed the Urban Growth Report which determined that the existing boundary contained 20 years of developable land. Metro council ultimately decided not to expand the UGB. This determination was based on the assumptions that the future presages smaller households that earn less money and have less need or financial ability to live in single-family housing. Thus, the concept of what constitutes a housing unit for the purpose of meeting UGB capacity 20-year capacity requirements was conveniently redefined to compress the anticipated future population into the existing UGB dimensions.

As I have argued previously in the *Quarterly Report*, the conclusion of zero-expansion was hot-wired by the process that Metro used to calculate the capability

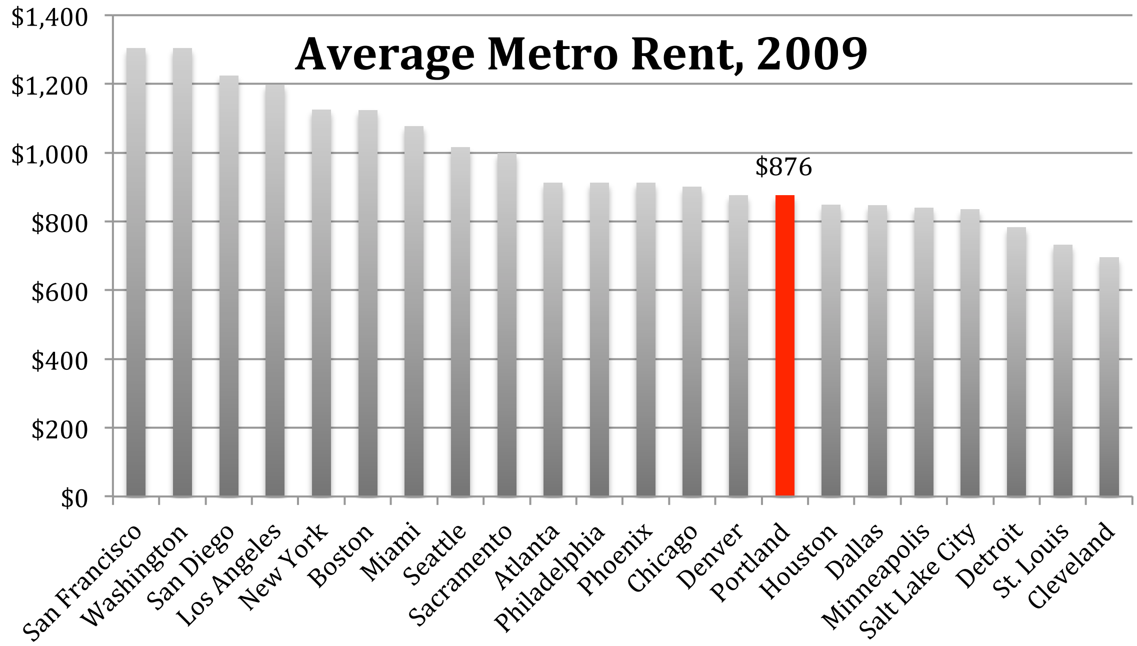
of the UGB to meet the anticipated housing and employment needs of the region for the next 20 years. Metro planners were given the directive to work with existing zoning given by the jurisdictions, regardless of whether that development capacity would be economically feasible. From there, anticipated housing units were assigned to that theoretical capacity, rather than located outside the UGB.

Figure 5. BLI Housing Development Capacity

As can be seen above diagram from the City of Portland, much of their future housing capacity is claimed in districts like Gateway, 82nd Avenue, Rockwood, and Montavilla. However, very little development activity is taking place in those communities, as they are some of the lowest rent districts in the region. As we noted earlier, apartment rents in Outer Southeast and Northeast Portland are only about $1.00 per square foot. To reach the conditions where mid-rise or high-rise development could take place, rents in these neighborhoods would need to rise to $2.00 or $3.00 per square foot. And if prices are that high in East Portland, they will be astronomical in higher income neighborhoods of the region. In essence, Metro planners treated zero-expansion of the Urban Growth Boundary as an absolute constraint, with housing rents forced to become the free variable to make that result possible. The resulting gentrification of East Portland is a policy outcome that is both unstated and inevitable.

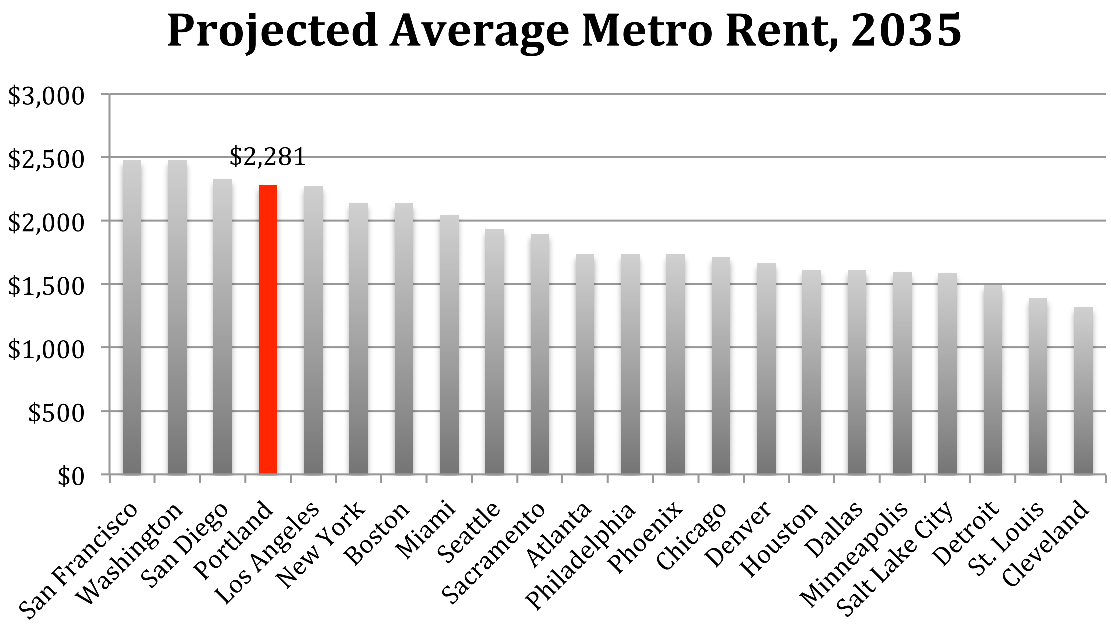
To their credit, Metro's planners have estimated the housing prices and apartment rents that would need to be achieved to reach those development targets. They anticipate that average rents in the Portland region to rise by 37 percent in inflation-adjusted terms in 20 years. Factoring in a 2.5 percent annual inflation factor, that would mean that rents would rise by 124 percent—more than doubling the current level. Home prices would rise even faster in Metro's estimation—148 percent in 20 years.

To assess what that level of appreciation would mean, I've arrayed the median gross rent in the Portland metropolitan area in 2009 against 21 other US metropolitan areas, selected for their size and location.



In that diagram, we find that the rents in the Portland region are somewhere in the lower half of the distribution, competing with large metropolitan areas such as Chicago and Dallas, and west coast competitors like Phoenix, Denver, and Salt Lake City. More importantly, Portland area rents are substantially below those in the major cities in California, such as San Francisco and Los Angeles, which are important sources of employment growth for this region. Economic development agencies in the region routinely recruit Bay Area software firms, arguing that while Portland may not have the same cultural or climate amenities of California, our housing is one-third less expensive and we're a short airplane flight away. Put differently, the software firm in Bay Area can convince some of their engineers to move to Portland, knowing that the engineer can afford to buy a nice house.

However, with the rent and price increases anticipated by Metro's 20-year plan, that value proposition evaporates. If rents in Portland rise by 37 percent more than the rate of inflation for apartments elsewhere, the large discount relative to the California cities vanishes. The engineer in Silicon Valley won't readily accept a move to Portland, and our competitors in Denver, Phoenix, Salt Lake City, and Austin will win those firm relocation opportunities.



In practice, the strategy of absolute containment of the region's population is likely to result in reduced employment opportunities and slower economic growth. Workers will require compensation for accepting jobs in a high cost, modest amenity region. If firms cannot achieve significant cost savings from locating in Portland, expansion will occur in other cities, whether that's our mountain state competitors, cities in Texas, or cities in the Southeast US, such as Atlanta and Charlotte. Children who grow up in the Portland area will more likely move to those cities to find employment, creating what I call the "Santa Barbara Effect."

Our city will remain a nice place with amenities, but it won't be a dynamic place where new employment and technology are developed. Homeowners will feel richer, but the resulting increase in home equity won't matter until they retire and move to Arizona or Nevada. Additionally, the brunt of the transition to Metro's policy to appreciate real property assets will be felt most harshly by the poor, who don't own property. Low-income households have been shown to be losers in regions that constrained spatial expansion in the face of population growth pressure. (Pozdena, 2002)

MOVING FORWARD

Metro officials justify their dedication to the zero expansion policy by arguing that they received only one proposal by a city that wanted to expand the urban growth boundary, Wilsonville, to accommodate new growth. And Metro is wary of expanding the UGB in places where there isn't a willing jurisdiction to plan for new growth. The largest UGB expansion that Metro has authorized in the last 35 years happened

in 1999 when 24,583 acres in Damascus were added. However, very little housing was developed in that area, due to a combination of lack of freeway access, lack of local infrastructure (i.e., arterial streets and sewers), and a new jurisdiction whose residents prefer to remain rural.

However, the housing problems of the region cannot wait for jurisdictions to step forward and sacrifice for the region. Housing markets tend to be regional in scope. If prices rise in Wilsonville, they will tend to rise in Tualatin and Tigard at the same time. And if Wilsonville agrees to allow new housing, the increase in supply will reduce prices in Wilsonville, Tualatin, Tigard, and many other communities, too, and Wilsonville will be left with the infrastructure cost. As a result, it's important for Metro to correct the incentives. The counties and the Metro regional government need to create a funding mechanism—such as a county-wide gasoline tax—to fund new road development. Revenue from the tax could be used to match local system development charge funds so that towns accepting new housing development can get assistance to cover the extra infrastructure costs. The cities that accept new growth would be rewarded for doing their part to solve a regional problem.

Finally, we need a new regional planning process that tests multiple scenarios, not just the single "zero expansion policy" that Metro has modeled. We need to accept that values that we hold—a protected resource economy, vibrant shopping districts, quiet residential neighborhoods, and housing that's affordable—exist in some conflict, with trade-offs between goals. The latest Urban Growth Boundary decision shows that housing cost impacts are ignored and no one is responsible for the gentrification that will ensue. ■

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