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Crisis *in* Portland's Real Estate Market

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Within the course of three years, Oregon has changed from being one of the least regulated housing markets in the nation to one of the most regulated housing markets. Whether measured by Inclusionary Zoning regulations in Portland, our long-standing system of Urban Growth Boundaries, our accumulation of Tenancy Regulation, or our recent entry in a list of four US states with some form of Rent Control, we have created a highly litigious, state- and municipally-controlled housing market.

These simultaneous policy initiatives have created problems for real estate industry participants and policymakers alike. For market participants, the shifting regulatory environment has created uncertainty about future market conditions, leading to reluctance of capital markets to invest in Oregon. For policymakers and policy analysts, the flurry of policy changes has made it very hard to determine the impacts of any particular piece of legislation, since any one of them (or a combination of several) might have caused the changes in market conditions being observed.

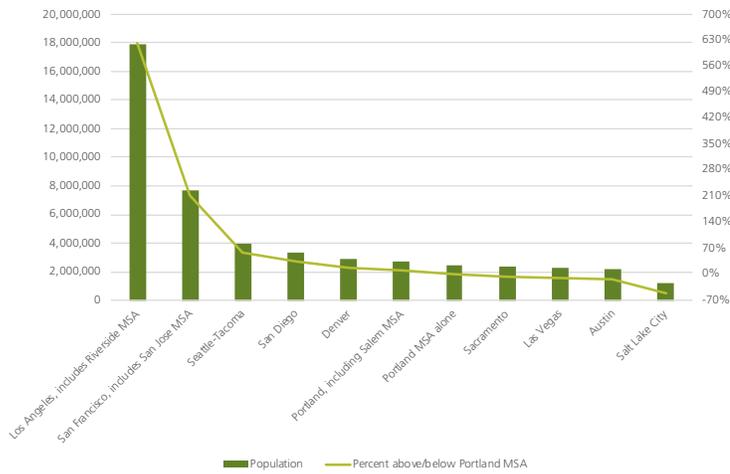
To assist in the analysis of these policies, the Portland State University Center for Real Estate and Multi-Family Northwest have entered into a partnership to create a “White Paper Series” analyzing the policy changes affecting the statewide and regional housing market. The Center has committed itself to a year-long series of monthly articles about different aspects of the housing market, using the talents of the Center staff and graduate students in the Master of Real Estate Development (MRED) program. We hope you appreciate the financial and economic analysis within these White Papers. Of course, the analysis and views expressed within each paper belong to the signed authors, and do not represent an “official” position of the Center for Real Estate, much less Portland State University

THE GROWING DEMAND FOR REAL ESTATE

The backdrop to the policy interventions of the last three years has been a booming economy and population in the Portland, Oregon metropolitan area. According to a recent Costar report, the Portland metropolitan area grew by about 24,000 residents with about 30,000 jobs added in the metro area (Anderer, 2019). Housing supply has had trouble keeping up with the demand, causing rents to rise rapidly. At the same time, Costar notes that, “Of the twelve west coast metros with at least one million residents, only Fresno has cheaper average rent than Portland” (Anderer, 2019).

The relative cheap rent and housing prices in the Portland area combined with a high quality of life and proximity to the San Francisco Bay area will support the continued flow of people moving to Oregon. California and Washington State have been the dominant two origins for migrants to Oregon for many decades. However, from a firm relocation or back-office relocation perspective, Portland is competing with many other Western metropolitan areas that lie within convenient commuting distance from San Francisco and San Jose: Denver, Phoenix, Austin, Salt Lake City, Boise, and Seattle.

METROPOLITAN AREA POPULATION, 2018



Many of these cities have a quality of life that competes with Portland. As a result, analysts who try to assess if real estate prices are “too high” for regional economic competitiveness should downplay our comparison to other “west coast cities” in favor of a comparison among similar-sized “western cities”. Economic theory and casual empiricism demonstrates that larger metropolitan areas tend to have higher real estate prices than smaller ones. Most of our “west coast” neighboring metropolitan areas have aggregate populations much larger than Portland: Seattle, San Diego, San Francisco-San Jose, and Los Angeles (see chart below).

As we can see from the table, Denver, San Diego, and Seattle-Tacoma are 18%, 35%, and 59% larger in population than the Portland metro area. Even adding in the Salem metropolitan area, where a quarter of the workers now work in the Portland area, doesn’t change the picture. Portland remains a small place compared to its larger “west coast” neighbors.

Urban economists such as Edward Glaeser of Harvard have long noted the economic advantage to workers and firms located in large metropolitan areas. Firms experience the agglomeration economies advantage of greater numbers of potential workers and increasing opportunities to research and innovate within an industry cluster. In turn, workers benefit from agglomeration economies through multiple employers seeking their services and unique cultural amenities, such as the quality and number of fine arts presentations, the number of colleges and universities, or the array of entertainment options. As a result, these larger regions tend to have higher housing prices and higher wages to compensate. The challenge in interpreting our position as a region requires analyzing whether Demand Factors, such as quality of life, amenities, and employment growth, or Supply Factors, such as housing regulatory constraints are driving the real estate price differences. Since measuring regional quality of life in more than a cursory way is a scientific challenge, we will focus on changes in prices and changes in population.

The true mega-regions in the table, Los Angeles and San Francisco, operate in an orbit of their own and have become major sources of population out-migration. Collectively, they represent 65% of the largest state in the United States. Historically, the high amenities of these regions have been a major driver in US population migration from the East to West. As can be seen in the chart below, California grew at more than double the rate of growth as the United States from 1910-1990.

Year California	California Population	Growth Rate Previous Decade	United States Population	Growth Rate Previous Decade ²
1920	3,426,861	44%	106,022,000	15%
1930	5,677,251	66%	123,203,000	16%
1940	6,907,387	22%	132,165,000	7%
1950	10,586,223	53%	151,861,000	15%
1960	15,717,204	48%	179,979,000	19%
1970	19,953,134	27%	203,984,000	13%
1980	23,667,902	19%	227,225,000	11%
1990	29,760,021	26%	249,623,000	10%
2000	33,871,648	14%	282,172,000	13%
2010	37,253,956	10%	309,330,000	10%
2018	39,557,045	6%	327,167,000	6%

However, since 1990, population growth in the state has fallen to the point that the California is expected to grow at less than average US population as a whole in 2010-2020. California remains a gateway city that attracts migrants from Asia and Latin America, however California has become a steady supplier of domestic migrants, primarily to the surrounding Western states. Dowell Myers, a demographer at the University of Southern California identifies housing costs as a major driver of out-migration, although factors such as the fertility rate and the changing patterns of immigration also play a role. With higher housing costs, along the peculiar property tax system and rent control system in California that favor long term residents, older residents in the state stay longer and younger families are more likely to leave.

Given these demographic factors and housing cost differences, Western cities such as Portland as destined to grow for a long time. The question is whether we maintain a healthy housing market and build new housing that satisfies these in-migrants, many of whom are arriving with substantial equity. If we fail to provide new housing to meet their needs, they will increasingly focus their demand on existing neighborhoods, driving up the price of housing. In effect, the choice is whether we reap the benefit of California's failed housing policies, or whether we repeat them.

IMPACT OF THE URBAN GROWTH BOUNDARY

The longest standing supply constraint on housing development in the Portland area is the Urban Growth Boundary, or UGB. Mandated by a state statute in the late 1970's, the UGB is intended to limit the places of urban settlement and preserve land for use by agriculture and the forestry industry. To limit its impact on urban development, the boundary is intended to provide for a "twenty-year land supply" for both housing and employment development. I put the word "land supply" in quotation marks because this concept has little meaning in economics. A community can live with a small land supply, using density to mitigate for the limited supply of land (think Brooklyn or Hong Kong). However, the impact of a tight land supply is higher land costs and housing costs. High prices are needed to support high density. Therefore, the amount of land that's needed for a 20-year supply depends upon prices.

The responsibility for whether the land supply is adequate depends upon the implementation by Metro, our regional government. Since 1980, the Portland metropolitan area has grown by 78%, while the land supply

inside the UGB has grown by only 10%. Since the mid-1990's, Metro has been following the "Region 2040 Plan", which favors using infill, redevelopment, and densification over greenfield development on the suburban fringe of the metropolitan area. With the assistance of urban planners at the City of Portland, Metro has been able to minimize the amount of UGB expansion required due to generous heights and allowed densities inside the City of Portland.

The problem with the densification strategy is that higher density development is more expensive and only likely to happen if rents and prices are sufficiently high. In the short run, the impacts are modest. Single family home developers can reduce square foot costs by changing from one-story ranch homes to two-story homes, and given the increases in land costs in recent years, almost all new homes in the region are two-stories. However, building at higher densities requires exceptional rents. In a recent study we did for Holland Development, we found that five story apartment construction requires 50% higher rents than two-story construction. Five-story development is typically four stories of relatively-inexpensive wood construction over a one floor concrete podium. "Four-over-one" construction is a common development type in the inner neighborhoods of Portland where rents and land costs are relatively high. Beyond five stories, developers need to switch to steel and concrete construction and this requires rents 50% to be higher again. There is some opportunity for mass timber construction to reduce this premium, but it's unproven and will require some rent premium. We only see unsubsidized high rise construction in the Portland's central business district, where per square foot rents are highest in the region.

The challenge is that generous zoning in Portland's neighborhoods permits city planners to assume an abundant potential housing supply, mitigating the need for new land. While medium density projects have been built along Williams, Vancouver, Hawthorne, and Belmont avenues, city planners have identified housing capacity along 82nd Avenue and the Gateway district. Development in these lower-income locations is unlikely to happen unless rents rise much higher than they currently are. More importantly, placing the region's housing supply future on high cost development almost guarantees that housing prices will become much higher.

The problem of the lack of land for subdivision development has been recognized by Metro. In December, 2018, the Metro Council approved a modest UGB expansion in four areas in Hillsboro, Beaverton, King City, and Wilsonville, representing the potential 9,200 homes. Unfortunately, 9,200 housing units represents only one year's worth of housing development in the region, and Metro doesn't intend to return to this question for another 4-5 years. The Center for Real Estate will be monitoring development in the UGB expansion areas, however obtaining land use approval and building infrastructure will take time. Unfortunately, despite Metro organizing an infrastructure bond for November, 2020, none of that money will assist these new development areas, and the four jurisdictions have been left to fend for themselves. And since the natural geography for housing markets is the metropolitan area, the cities won't experience lower costs while neighboring towns do not. As a result, these cities are being asked to perform a regional benefit, without any regional assistance or partnership.

INCLUSIONARY ZONING LIMITS APARTMENT DEVELOPMENT PORTLAND

A second major impediment to housing development in the region comes from the City of Portland's Inclusionary Zoning regulations. In 2017, the state legislation removed a long-standing ban on municipal inclusionary zoning, which mandates that developers of apartments set aside a fraction of their units to be rented at below market prices to households of limited incomes. While this kind of regulation seems innocuous and well-intended, the impact on development can be quite dramatic.

The City of Portland immediately adopted an ordinance that meets the maximum that the state legislature allowed. Under the new rules, developers of projects of 20 or more housing units have to rent 20% of those units at prices substantially below market levels. The regulation covers all residential development, including for-sale condominiums and senior housing. The City has offered some development incentives, but typically those benefits are short-lived, while the rent restrictions are required to last for 99 years. The regulations have been particularly onerous on downtown development, since the affordable rent levels were set at county-wide levels. With market rents reaching their highest levels downtown, the regulation has made downtown apartment construction not feasible.

To limit any immediate impact, the City allowed for projects that were submitted prior to February, 2017 to be exempt from these onerous regulations. Property owners and developers put forward a flood of development applications, representing some 12,000 housing units. Most of those projects have moved forward to completion, leaving the apartment market somewhat soft. However, very few apartment proposals have been put forward since this February, 2017 deadline. As a result, most experts expect apartment rents to rise in the next few years as little new supply is being added to the market.

Ultimately, this kind of regulation is a development tax. In the City of Seattle, for example, the inclusionary zoning regulation was designed to generate cash for the city to develop affordable housing, and the developer of a recent project found that it had to pay 5% of its development costs in the form of an in-lieu fee to the City. In Portland, the in-lieu fees were set closer to 15% of development costs, so that most developers considering their options have been forced to include the affordable units inside their projects, creating more complications for selling their projects to outside investors.

In any case, the Center for Real Estate will be following this issue in an upcoming article in this White Paper series, but the basic concept is that investment capital is mobile, and if the regulations are sufficiently onerous, housing supply will dry up and rents will rise to even higher levels.

There's also the broader question of whether this sort of affordable housing initiative should be funded by developers and apartment tenants or by taxpayers as a whole. The problem of the shortage of housing development was largely created by local development regulations, not the market. And if anything, new housing supply will reduce market rents, reducing the cost of living for everyone. The inclusionary zoning concept taxes that new supply, making the underlying problem only bigger.

OREGON'S STATEWIDE RENT CONTROL MEASURE

A third pressing issue for housing development has been the implementation of rent control across the state. Ostensibly, this legislation was written in 2019 in the mildest form to limit the impact on new development and preclude the more ambitious regulations sought by City of Portland officials. Rent increases were limited to 7% plus the rate of inflation and were limited to properties that were 15 years or older.

Of course, the problem is that these two key provisions can be changed by future legislatures, and even new development projects will require some projection of future rents. Typically, apartment developers will project their construction costs, operating costs, and rent levels for an indefinite future. Then at some distant point – often 10 years into the future – they will convert their net operating income into an asset value using capitalization rates.

The problem with Oregon's 15-year threshold is that all new housing development will eventually become a 15-year old project, with rents being subject to legislative constraints. Lenders and investors will force developers to use higher capitalization rates given the uncertainty of future rent control regulation. And since high cap rates mean low asset prices for the developer, apartment developers will be forced to wait for higher initial rents in order to make the new projects pencil out.

A further problem with the legislation is that cities and counties will need to greatly expand their monitoring of rent levels and expand the housing court system. A natural reaction by landlords to restricted rents is reducing apartment quality, whether this means adjusting thermostats, reducing garbage collection, or allowing apartment amenities to deteriorate. Many small landlords are selling their holdings or have been forced to use third-party management to insure they are in compliance with the new regulations. In some cases, landlords are being advised to raise rent levels faster than planned to insure they won't be affected by future regulation. All of this suggests an unintended regulatory compliance burden that apartment owners and local governments are unprepared.

Again, the Center for Real Estate is committed to a study of this problem in a future White Paper. However, the academic literature has little good to say about rent control. Rent control discourages new housing supply and encourages over-consumption of apartments by tenants. The benefits of rent control accrue to long-term tenants, many of whom are not low-income. And with supply reduced, market rents tend to rise, creating burdens for young adults, newly-formed households, new arrivals to the state, and divorced couples.

In the bigger picture, one of the characteristics of housing markets in the United States is the relative ease of development and low cost of housing relative to incomes. Unfortunately, Oregon has joined a relative small number of places in the US with rent control, California, New York, New Jersey, and Washington, DC, each of which have substantially higher rent levels. The experience in these places and elsewhere is not promising.

THE UNINTENDED CONSEQUENCES OF REGULATION

The net effect of inclusionary zoning and rent control has been to reduce apartment supply in Portland, which has been the mainstay of housing development since the Great Recession. Yet the connections between the legislation and its impact in 2021 and 2022 has been blurred because of the City's grandfathering clause for inclusionary zoning. Rents and prices have been stabilized for the past year, as developers and investors have sought regulatory relief. Yet rents are likely to happen in the future. And because so many actions are happening at the same time, legislators and local officials have cover for the impact of their work.

Ultimately, state legislators and local government officials have painted a false image of the inefficiency and the inequity of the rental housing market. The apartment market is typified by thousands of small suppliers, none of whom control enough of the market to have any market power. Absent regulation, they have strong incentives to maintain high quality levels and fill vacancies. Landlords desire to increase rents is constrained by their competition. Tenants gain their power in the apartment marketplace by moving when a landlord doesn't offer the apartment at a fair price. The true power over the market begins with Metro's monopolistic control over land supply and the legislature's intervention in the development process and landlord-tenant laws.

Regarding equity, which has become the North Star for legislators and officials at the city and state level, it's a common canard that landlords don't develop housing for low-income households or build for the low-income side of the market. This claim ignores the long-lived nature of housing and the decline in housing quality that occurs with time, which in the economics literature goes by the name of "filtering". The average existing home price is typically \$100,000 less than the average new home price. Most newly-built housing is occupied by higher-income households, largely because of its higher quality and higher prices. As they move into the new housing, they free up existing household, which has depreciated or filtered downward. So just as one finds affordable furniture and affordable automobiles on Craig's List or along 82nd Street, affordable housing is found by looking for the housing built 20 or 40 years ago that has depreciated in value. To keep the process of filtering operating so that lower-income households find the apartments they need, we need less regulation so that more new housing is built.