Economical Rental Housing by Design for Communities That Work

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Introduction

This paper advocates for a market-rate, unsubsidized approach for producing economical rental housing largely intended for service and line-production workers—workers that account for 38 percent of national private and public jobs. The paper includes primers on rental housing economics and policies and a report on efforts thus far to implement our recommendations. The authors will be updating this paper as the first developments move forward and as we acquire new information. At a later date, we intend to broaden our scope to include ownership housing.

In this paper, we make the case that (mostly local) regulation of apartment development is misguided and has harmed workers and their employers—and thus has also harmed the local economy in general. In making our case, we do not suggest that local governments are perversely motivated, that voters are venal, or that local officials are incompetent. Rather, we recognize that the status quo exists because political actors created it in the belief that it would be a good system. As is often the case, such political and policy efforts had unintended consequences.

The reality is that the existing system disproportionately benefits existing homeowners, disproportionately harms workers who need economical rental housing, needlessly drives up the cost of economical rental housing, makes it more difficult to launch new local businesses and expand existing local businesses, and harms the locality's potential for economic growth. We wrote this paper in the hope that local governments that are concerned about these workers and that want to stimulate local economic growth would embrace the policy changes we suggest in recognition of the broad-based benefits of a greatly increased supply of market-rate economical rental housing.

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[1] This paper has been prepared for the first AEI conference on economical housing by design. The first conference focuses on rental housing and is sponsored by the National Multifamily Housing Council (NMHC). The views and opinions expressed in this article are those of the authors alone and do not necessarily represent those of the American Enterprise Institute or the NMHC.

We do not suggest federal policy changes, and we do not wish for anyone to force local governments to adopt the changes we suggest. Instead, we trust that those local governments that try our suggestions will succeed, that other local governments will notice, and that our ideas will spread to the extent—and only to the extent—that they work in practice.

Brief

There is strong demand by workers for apartments that rent for $600 to $900 per month (plus utilities) and are located near jobs.[2] Yet neither the market-rate private rental market nor the subsidized private and public rental market are meeting this demand. In the case of market-rate private rentals, a host of unwise government policies results in minimum achievable rents that are over (typically *well* over) $1,000 per month. In the case of subsidized private and public rentals, the political reality is that available subsidies are overwhelmingly targeted to households that cannot work or are marginally attached to the workforce.[3] Moreover, the current subsidy system is a bad way to address the need for worker housing for two reasons: (1) the amount of subsidy that would be needed to address worker housing needs via the existing subsidy system is so large that there is zero practical likelihood of success; and (2) as we will show in this paper, it is possible to meet worker housing needs without subsidies, by making better policy choices.

In this paper, when we talk about housing for workers, we are talking about the great middle of the rental market—service workers, line-production workers, and entry-level workers in other parts of the economy. Service and line-production workers' wages average about $26,000 per year (with surprisingly little variation across the country) and nationally account for 38 percent of all public and private jobs. Entry-level workers in other parts of the economy have similar incomes. In this paper when we use the term "workers" we mean this large segment of the rental market, unless we specifically state otherwise.

In this paper, we use the term "economical" because we are advocating for unsubsidized apartments that have low rents not because of regulation but because—like low-price hotel rooms and low-price cars—these apartments are designed, developed, and operated to achieve a low price point (i.e., rent). We use the term "by design" to emphasize that housing—and the regulatory system through which it is developed—is designed to produce serviceable and economical housing with low rents. We use the term "communities that work" to emphasize that we are focusing on the great middle of the rental market, for those who work full time.

The crux of the problem is that in the United States we have tended to overregulate development—driving costs up—and we have tended to provide poorly designed, costly subsidies so that a trickle of affordable apartments can be developed. This is the wrong approach.

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[2] Over and above the obvious economic and time-savings benefits of a shorter commute, a relatively short commute can allow for one fewer car (or for no car at all).

[3] Sixty-eight percent of working-age households getting federal housing assistance receive the largest portion of their income from Temporary Assistance for Needy Families, state-funded cash assistance, or other nonwork sources. Congressional Budget Office, *Federal Housing Assistance for Low-Income Households*, September 2015, https://www.cbo.gov/publication/50782.

Policymakers (mostly state and local) need to change the policies that have driven costs up, so that private developers can meet the demand without subsidies. Instead of driving up costs and using subsidies to reduce the impact on tenants, we should be driving costs down by reducing regulations and letting the rental housing market work roughly the same way the markets for cars and hotels work—markets in which producers deliver a wide array of cars and hotel rooms, giving consumers a full array of choices, without subsidies. In saying this, we are not arguing for no regulation; instead, we are arguing for different regulation that allows and encourages creation of rental housing at low, unsubsidized rents.

This can be accomplished through a two-way bending of the cost curve: (1) cost-effective land-use regulations through higher density, reduced parking requirements, reduced local regulations and costs, expedited processes, and reduced fees; and (2) for local governments to allow—and for developers to utilize—economical design, construction, and management techniques.

Unleashing private enterprise will expand supply, allowing supply and demand to reach equilibrium at lower rents. The greatest beneficiaries would be service, light manufacturing, and entry-level workers—largely low- and moderate-income workers and minorities.

In this paper, we will demonstrate:

1) By substituting a more sensible regulatory framework, we can make it possible for developers to produce apartments renting between $600 and $900.
2) Rent that is $600 to $900 per month, without subsidy, is low enough to meet workers' demand.

We will illustrate these points by using a case study from Sarasota-Bradenton, Florida, a market in which new apartments typically rent for $1,200+, but in which $600 to $900 rents were readily feasible once a local developer demonstrated how, by getting out of the way, local governments could be part of the solution instead of being part of the problem.[4]

[4] "Harvey Vengroff—the shrewd founder of billion-dollar Sarasota-based collections agency Vengroff Williams, Harvey Vengroff, 75, has become the face of affordable housing in Sarasota, converting old motels to rental units and now building a new 393-unit apartment complex for the working poor. (When the city commission tried to impose annual inspections on that project, he stormed out and won approval on his own terms.) An avid sailor usually dressed in board shorts and boat shoes, he acts tough, but he cares about his tenants, seeing them as people with problems that can afflict us all. Hates bureaucracy, loves control and won't be intimidated." Susan Burns et al., "Meet the 25 Most Influential Men and Women in Sarasota Today," *Sarasota Magazine*, August 31, 2016, https://www.sarasotamagazine.com/articles/2016/8/31/meet-the-25-most-influential-men-and-women-in-sarasota-today. "[Harvey Vengroff of Sarasota], the wealthy philanthropist purchased an old motel in Bradenton to convert into affordable rental units. And he moved quickly after closing on the 240-room Knights Inn a month ago. The First Street property offers furnished apartments for only $625 a month (which generously includes water, electricity, cable and internet), and more than 10 rooms are already occupied. Vengroff, who paid $4.4 million for the motel and then pumped $1.5 million into renovations, also plans to build apartments on the adjacent five acres. This is not the first venture into affordable housing for the businessman, who has also converted motels in Sarasota [and Manatee] County. Kudos to Vengroff for his dedication to providing affordable housing — and requiring tenants to hold jobs." Claire Aronson, "Some Progress on Affordable Housing," *Bradenton Herald*, July 29, 2016, http://www.bradenton.com/opinion/editorials/article92612172.html. Note that all of Vengroff's developments (1,500 existing and 700 planned units) are operated as profit-making, not philanthropic ventures.

In this paper, we will focus on the middle of the rental housing market. We will not address the roughly 18 percent of rental housing that is designed for those who cannot or do not work full time, and we will not address the roughly 25 percent of rental housing that is luxury housing for those who could purchase homes but choose to rent instead.

In this paper, we will keep the discussion at a summary level. We welcome email inquiries from those who want to dig deeper; our contact information is included at the end of this paper.

Communities Have Four Choices in Meeting Workers' Rental Needs

A local community that wants more economical rental housing has basically four choices:

1) **Expand affordable housing by subsidy.** This option is expensive. Subsidies are scarce, and the subsidy system results in high development costs and long development times. It usually requires heavy upfront capital and long-term operating subsidies, along with specialized expertise in navigating the various governmental entities providing the subsidies. This generally leads to a concentration of units in high-poverty, high-minority areas.[5] The political sell is difficult at best. Finally, subsidized developments generally serve households with lower incomes than those of the workers we are targeting.[6]
2) **Maintain the status quo.** Many service and light manufacturing workers commute 20–30 miles (or more), which can account for up to 20 percent of income, adding substantially to total housing cost. The status quo risks draining economic vitality and the expansion of manufacturing and tech industries.
3) **Provide or expand transportation subsidies and provide subsidies to retain or expand manufacturing jobs.** The track record of protectionist (job-retention) subsidies is dubious. While we are in favor of allowing workers to make their own choices about commuting distances, we believe that the best approach is to provide a wider range of choices, including choices within a short commuting distance.
4) **Actively encourage market-rate economical rental housing by design for communities that work.** This approach requires no subsidies. It creates housing for workers we are helped by every day, in stores, restaurants, hotels, and health care, leading to an easier political sell. It promotes economic vitality by allowing the locality's manufacturing and tech industrial base to be maintained and expanded. It helps workers reduce their transportation costs. As the supply of economical apartments increases to meet demand, rents will reach equilibrium at lower price points. The likelihood of homelessness will be reduced.

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[5] About 49 percent of subsidized units and 24 percent of market-rate rental units are in census tracts with a poverty rate of 20 percent or more. About 46 percent of subsidized units and 25 percent of market-rate rental units are in census tracts with a black or Hispanic population share of 50 percent or more. Joint Center for Housing Studies of Harvard University, *America's Rental Housing: Expanding Options for Diverse and Growing Demand*, December 9, 2015, Figure 27 and 29, http://www.jchs.harvard.edu/americas-rental-housing.

[6] Of Low-Income Housing Tax Credit households, 43 percent have incomes of less than or equal to 30 percent of area median income, and 19 percent have incomes of 31–40 percent of area median income. For a two-person household, this translates into an annual income of less than $15,000 and $20,000, respectively. New York University Furman Center for Real Estate and Urban Policy, "What Can We Learn About the Low-Income Housing Tax Credit Program by Looking at the Tenants?," October 2012, http://furmancenter.org/files/publications/LIHTC_Final_Policy_Brief_v2.pdf.

The Space Between: The Great Middle of the Apartment Market

There are really three apartment markets in the United States.[7] Roughly 25 percent is luxury/middle-income rental housing, for those who could buy homes but choose to rent instead. Roughly 18 percent is subsidized (usually deeply) and is for those who cannot or do not work full time. The space between is roughly the remaining 60 percent of the rental market, largely occupied by service workers, line workers in light manufacturing, and entry-level workers in other parts of the economy.[8] In this paper, we will focus on the space between—the broad middle of the apartment market.

Figure 1. The Space Between: Market-Rate Apartments at Moderate Rents

Note: Estimates are for apartments with 10 or more units.
Source: Joint Center for Housing Studies of Harvard University, *America's Rental Housing: Expanding Options for Diverse and Growing Demand*, December 9, 2015, http://www.jchs.harvard.edu/americas-rental-housing; and authors' calculations.

Market-rate tenants (the left and middle portions of the existing stock shown in Figure 1) have an average annual income of $32,000, 75 percent have one or two household members, and 78 percent have no children.[9] As discussed earlier, we are targeting workers in the services industries, light manufacturing, and entry-level positions; these jobs have annual wages that average about $28,000.

Interestingly, wages for these jobs do not vary much across the country, as we will discuss later in this paper. Just as jeans and pizza cost about the same everywhere in America, the workers who produce and sell our

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[7] Ibid. The rental market totals 43 million occupied units and includes both single-family (1–4 units) residential properties (60 percent of occupied units) and apartments of 5+ units (40 percent of occupied units). This paper's focus is on apartments, consisting largely of 0–2 bedroom units, since the apartment stock is more concentrated in urban and suburban areas and is thus closer to jobs. Additionally, most of the new production that could serve this market will take the form of apartments.

[8] The Greater Minnesota Housing Fund is the source of the term "the space between." See Greater Minnesota Housing Fund, *The Space Between: Realities and Possibilities in Preserving Unsubsidized Affordable Rental Housing*, June 2013, http://www.gmhf.com/downloads/publications-research-reports/The-Space-Between.pdf.

[9] National Multifamily Housing Council, "Quick Facts: Resident Demographics," http://www.nmhc.org/Content.aspx?id=4708.

clothes and food and provide most of our health care get paid about the same. In most places, these workers live too far from their jobs and spend too much of their incomes on rent, tenant-paid utilities, and commuting costs. This needs to change, for the good of the economy and from the standpoint of individual economic opportunity.

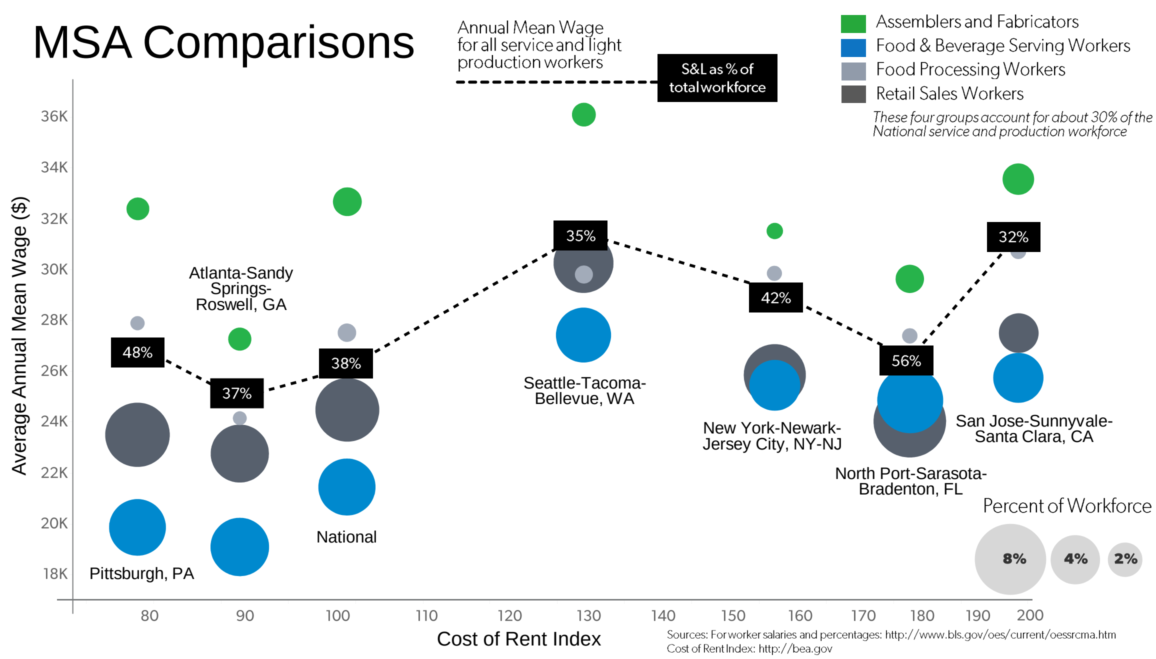
The Demand Side

Figure 2 demonstrates several key demand factors:

1) Nationally, service and line-production workers account for 38 percent of all private and public workers.
2) The percentage of such workers does not vary that much across metro areas. Places such as San Francisco at 31 percent (not shown) and San Jose at 32 percent (shown) set the lower boundary, and places such as North Port-Sarasota-Bradenton at 56 percent (shown) and Savannah at 56 percent (not shown) set the upper boundary.
3) Likewise across metro areas, retail sales workers and food and beverage serving workers are the largest occupational subcategories.
4) There is also substantial wage similarity across metros—the weighted average annual wages of service and line-production workers.

There is a wide disparity in one metric—cost to rent. Places such as San Jose have rents that are double and wages that are 20 percent higher than the national average, while places such as Pittsburgh have rents that are 80 percent and wages that are 4 percent higher than the national average.

Figure 2. Metropolitan Statistical Area Comparisons



The Solution: Economical Rental Housing by Design

The challenge of increasing the supply of economical rental housing by design faces most localities around the country. The solution is a coordinated two-way bending of the cost curve.

1) **Cost-effective land-use regulations.** To produce needed housing for workers, we need higher density, reduced parking, expedited processes, and reduced fees. Other needed rule changes will encourage use of repurposed and refurbished existing buildings. Other changes are needed in how local government implements its rules: providing direction to staff for liberal construction of requirements and establishing "good enough" and "substantial equivalence" standards for code compliance. We will discuss each of these interventions in more detail later in this paper. These changes could, and perhaps should, be limited to economical rental housing developments.
2) **Utilization of economical design, construction, and management techniques**. In the status quo, most of a developer's effort goes into getting a "yes" from the local government, and many design decisions—that could be made in the direction of economical housing—are either prohibited by local regulation or made by local officials rather than developers (typically driving up costs). When that process becomes easier, developers can and will shift their attention to speedily designing and building rental properties that are economical to produce, operate, and maintain in good condition over a long period of time. The solution is for local government to allow and encourage economical design approaches that are now either discouraged or prohibited.

A Seemingly Similar Market That Works Properly: Cars. The auto industry produces about 17 million new cars a year, with prices ranging from about $13,000 to more than $70,000. Financing is widely available and highly competitive. Roughly 44 million used cars are sold each year. Good used cars can be purchased for $5,000 to $10,000. Higher-risk purchasers pay higher interest rates. When the car owner does not make the payments, the lender can easily locate and repossess the car.

Basically, anyone with a job can afford to purchase a serviceable used or new car. The car business is regulated, but no one prohibits buyers above a certain income from purchasing certain types of cars, and there is no political pressure for subsidies for low-income car buyers.

A Seemingly Similar Market That Works Properly: Hotels. Across America, roughly 5 million hotel rooms are available at an astonishingly varied set of price points. It is routine to be able to rent hotel rooms for under $50 per night and more than $200 per night in the same city. Guests pay in advance.

Basically, anyone who wants a hotel room and can pay for it can rent one, without subsidies. The hotel business is regulated, but no one prohibits customers with incomes above a certain level from renting lower-end hotel rooms, and there is no political pressure for subsidies for low-income hotel guests.

It Works for Cars and Hotels, and It Will Work for Apartments Too. No one would advocate prohibiting, by regulation, cars that sell below (say) $30,000 and providing a trickle of subsidies so that some people who now purchase Chevrolets could purchase Cadillacs. No one would advocate prohibiting, by regulation, hotel rooms that rent below (say) $150 per night and providing a trickle of subsidies so that those who now rent hotel rooms at $50 per night can purchase a hotel room at $150. Yet that is basically exactly what we have done in the rental housing world. We have instituted minimum requirements that are inappropriate, we have delegated design decisions to government officials that should instead be made by developers, and we have forced workers to pay more for rental housing than they would choose to pay if we had made better policy choices.

Overview of Case Study

The case study focused on Sarasota and Manatee counties in southwest Florida. A creative developer, over a period of 14 years, had built up a portfolio of about 1,500 unsubsidized economical apartments consisting of refurbished and repurposed units. These units are largely occupied by service workers with incomes averaging about $27,000. His next goal was to build 400 new, market-rate, economical apartments at a downtown Sarasota location, with efficiency to two-bedroom units renting at $650–850 plus utilities.

Both counties and the four largest cities (North Port, Sarasota, Bradenton, and Venice) had all publicly expressed concern about a lack of economical housing for service and line-production workers (more than half of the local workforce with wages that average about $26,000). There was extensive media coverage of the problem in general and of the developer's proposed downtown Sarasota project in particular.

Subsequently, Manatee County quickly approved the same developer's proposal to create an unsubsidized 360-unit project (240 renovated units in an existing motel and 120 newly constructed two-bedroom units) with furnished efficiency units renting for $625 including utilities and the new units renting for $750 (including water but not electricity). In September 2016, Sarasota Magazine declared the developer to be "the face of affordable housing in Sarasota."[10]

The conventional wisdom was that economical rental housing could not be developed in Sarasota and Manatee counties without extensive subsidies. The conventional wisdom was wrong. In reality, the combination of a creative developer and local government willing to help bend the cost curve was sufficient, with no subsidies.

We will now give you a series of primers, on technical and semitechnical topics that matter. We will then present the case study in more detail.

Primers

Primer #1: Rental Housing Costs and Values

Why This Primer Matters. You need to understand the economics of apartment development and operations before you can appreciate the connection between the way we have regulated apartment development—driving costs up—and the fact that apartment rents are too high for workers.

[10] Susan Burns et al., "Meet the 25 Most Influential Men and Women in Sarasota Today," *Sarasota Magazine*, August 31, 2016, https://www.sarasotamagazine.com/articles/2016/8/31/meet-the-25-most-influential-men-and-women-in-sarasota-today.

It costs a lot to be a landlord (Table 1). Here are the major categories of costs:

- **Capital Costs.** Typically, the largest capital cost is the mortgage payment (i.e., the return to the lender to reflect cost of money and risk that the loan will not be repaid on time). There is also cash flow, which most people would think of as "profit," but is actually a cost—it is what the owner pays to whoever invested the down payment (in financial terms, the equity capital as opposed to the mortgage loan, which is the debt capital). In small-scale rental housing, typically the landlord made the down payment. In large-scale rental housing, typically most of the down payment came from third-party investors.
- **Operating Expenses.** Operating expenses mainly consist of real estate taxes, property insurance, utilities paid by the landlord, maintenance and repairs, and management. For a typical two-bedroom apartment, those costs total around $400 per month on a national average basis.
- **Rent Loss.** Rent loss occurs because the unit is not occupied ("vacancy loss"), because the rent is due but is not collected ("bad debt loss"), or because the landlord chooses to offer a discount ("concession loss"). For typical rental housing, these costs are around 7–10 percent of the market rent.

For a typical apartment in the space between, the landlord's revenues and costs might look like this (per unit per month):

Table 1. Landlord's Revenues and Costs for a Typical Apartment (Per Unit, Per Month)

Market Rent	$700
– Rent Loss	– $50 (about 7–8 percent of market rent)
– Operating Expenses	– $400 (about 55–60 percent of market rent)
= NOI	= $250
– Mortgage Payment	– $175 (about 20–25 percent of market rent)
= Cash Flow	= $75 (about 10 percent of market rent)

Source: Authors' calculations.

At this point, we need to introduce an important real estate finance term: Net Operating Income (NOI) is the cash flow after the operating expenses but before the capital costs (mortgage loan payment and return on equity). In our example, the NOI is $250 per unit per month (about 35 percent of the market rent). The reason that NOI is important is that, for apartments and other commercial real estate, the NOI determines the value. For single-family homes, probable selling price is primarily a function of what other similar homes are selling for ("comparable sales method", in appraisal terminology). For commercial real estate, comparable sales still matter, but the primary determinant of value is the expected stream of NOI (the "income method," in appraisal terminology).

Our example rental unit, with a NOI of $250 per unit per month, might be worth around $45,000 to $50,000, based on the levels of return that apartment debt and equity investors require today (about 6–7 percent).

Interestingly, as the market rent changes, the operating expenses do not change much at all (Table 2). As a result, the value of the property changes dramatically as the market rent changes. Continuing our example:

Table 2. Calculating Market Value from Market Rent, for Worker Rental Market

Market Rent	$900	$800	$700	$600	$500	$450
– Rent Loss	– $65	– $60	– $50	– $45	– $35	– $25
– Operating Expenses	– $400	– $400	– $400	– $400	– $400	– $400
= NOI	= $435	= $340	= $250	= $155	= $65	= $25
Market Value (Roughly)	$90,000	$70,000	$50,000	$30,000	$13,000	None

Source: Authors' calculations.

Under our existing regulatory systems, it costs about $150,000 to $180,000 per unit to develop new apartments in most of the US. To achieve rents in the $600–900 range, we would have to reduce development costs significantly. This can be done by the two-way bending of the cost curve that we discuss in this paper.

In Table 2, we have assumed that operating expenses do not change at all as the market rent decreases. That is a bit unrealistic because real estate taxes should decrease as market value decreases. However, it is also true that—by and large—the lowest rents are found in the oldest units, and maintenance costs in those units tend to be a lot higher than in the newer units that command the higher rents. So, on balance, we think it is okay—pre-cost curve bending—to show operating expenses being the same regardless of rent level. We have also pegged the market value at zero when the market rent is at $450, and there might be some value—if, for example, there is an opportunity to do a lot of fixup so as to raise the rent to $700 or $800. But, by and large, once the market rent drops close to operating expenses, the unit is essentially without value, and eventually it will be abandoned when the owner faces the unpleasant choice of either throwing good money after bad or walking away.[11]

In Table 3, we look at the high end of the workforce rental market and the low end of the luxury market. What if the market rent is higher than $900?

Table 3. Calculating Market Value from Market Rent, for High End of Worker Rental Market to Low End of Luxury Market

Market Rent	$900	$1,000	$1,100	$1,200	$1,300	$1,400
– Rent Loss	– $65	– $75	– $80	– $90	– $100	– $110
– Operating Expenses	– $400	– $400	– $400	– $400	– $400	– $400
= NOI	= $435	= $525	= $620	= $710	= $800	= $890
Market Value (Roughly)	$90,000	$105,000	$125,000	$140,000	$160,000	$180,000

Source: Authors' calculations.

[11] In the meantime, the low-value property will tend to be transferred to increasingly unscrupulous landlords who are interested in maximizing short-term income and deferring all repair costs. In many cases this means being indifferent to drug use, prostitution, and other activities inimical to communities that work.

Perhaps you are wondering what it costs to develop a new apartment property under a typical current local government regulatory structure. The answer varies across the country, but the national median asking rents for new multifamily units is $1,400,[12] implying total development cost (land, buildings, professional fees, interest, developer fee, and so forth) of $180,000 per unit. Development costs are lower in places such as Tulsa and a lot higher in places such as San Francisco. It costs about the same per unit—under today's status quo—to develop a subsidized property as it does to develop a market-rate property.

Primer #2: Why the New Apartments We Get Are Not the Ones We Need

Why This Primer Matters. It is important to understand what workers actually pay for housing and why they cannot and will not pay the $1,400 that new apartments cost in today's regulatory system.

Say that the tenant-paid utilities are $100 a month and that the worker's household pays 33 percent of its income for housing (including utilities).[13]

$1,400 + $100 = $1,500 ÷ 0.33 = $4,500 a month income needed x 12 = $54,000 per year income needed

But the median market-rate tenant household earns about $32,000, and the typical worker earns about $28,000. So, $1,400 in rent is a nonstarter, and that is before utilities and commute costs.

As noted earlier, this picture is pretty much all wrong. We should be producing economical, new (or repurposed) efficiency, one-, and two-bedroom apartments that rent for $600–900 per month and are located near jobs.

- Efficiency (repurposed):
  $625 (includes utilities) ÷ 0.33 = $1,900 a month income needed x 12 = $23,000 per year income needed
- Efficiency (new):
  $600 plus $100 for utilities = $700 ÷ 0.33 = $2,100 a month income needed x 12 = $25,000 per year income needed
- One bedroom (new):
  $750 plus $125 for utilities = $875 ÷ 0.33 = $2,650 a month income needed x 12 = $32,000 per year income needed
- Two bedroom (new):
  $850 plus $150 for utilities = $1,000 ÷ 0.33 = $3,000 a month income needed x 12 = $36,000 per year income needed

In the preceding, we did not discuss three-bedroom apartments because, as a practical matter, the workers on whom we are focusing do not have family sizes that require three bedrooms.

[12] Joint Center for Housing Studies of Harvard University, *America's Rental Housing,* Figure 2.
[13] Typical renters in the space between spend 30–35 percent of their incomes on rent and tenant-paid utilities.

Primer #3: Why Are $600 to $900 Rents Good Enough?

Why This Primer Matters. You may be thinking that we need to get rents even lower, and indeed that would be a pleasant outcome if we had unlimited resources. This primer will show you the rents that are needed to meet the demand from workers—a need that is not being met today. And if, as we argue, this need *can* be met without subsidies, we should do so, without chasing the impossible dream of achieving something better through a new subsidy system that has zero chance of being legislated, that has less than zero chance of being adequately funded, and that probably would not work even if it were legislated and funded.

Typical households of service and line-production workers pay 30–35 percent (call it 33 percent) of income for rent and utilities (even more once the cost of commute is included).[14] Over time, we would like to see those percentages go down, and we think they will go down in localities that adopt our recommendations. But, for now, Table 4 shows what that implies (assuming tenant-paid utilities at $100–150 per month depending on bedrooms).

Table 4. Monthly Economical Rent by Yearly Income

Yearly Income	Monthly Economical Rent
$25,000	$600
$31,000	$750
$36,000	$850

Source: Authors' calculations.

In Sarasota (the focus of our case study), new apartments rent for $1,200+. The demand, however, is for apartments from $600 to $900. Our case study will show that rents of $600–900 are readily achievable without subsidies.

By changing the ground rules under which apartments are developed, we can decrease a developer's break-even price point significantly, allowing workers to find economical rental housing located close to where they work. This would be a great improvement, and it can be done without subsidies. This paper's purpose is to encourage interested local governments to do exactly that.

Primer #4: Affordability and Why It Is a Largely Pointless Conversation

Why This Primer Matters. Typical readers of this paper probably have heard a lot about "affordable" housing and the notion that people should not pay more than *x* percent of their incomes for housing. We think that most of what is written today about "affordability" is simplistic and misguided. Moreover, the conventional wisdom treats development costs and rents as givens and assumes that the answer must be

[14] This figure is based on authors' analysis of HUD's "Worst Case Needs" for nonsubsidized renters with incomes in the range of Target Workers.

more subsidies. We think the answer is to drive development costs down so as to give workers a better and more economical set of choices.

Currently, there is a standard of affordability that undergirds much of public policy in the rental housing arena: that an affordable level of housing costs (rent plus tenant-paid utilities) is 30 percent of adjusted income (gross income minus certain offsets, mostly for dependents, elderly, or disability status; unusually high medical expenses; and child care expenses that allow an adult to work).[15] For this purpose, gross income includes cash income of all sorts but does not include noncash income such as government vouchers for food or housing. In our view, the best that can be said of this dubious standard is that it has been legislated after 50+ years of the most vigorous sort of political pushing and shoving. We rate this standard as dubious because it is so easy to criticize, from both ends of the political spectrum. We summarize the strongest criticisms in the next few paragraphs.

There is a powerful argument that—regarding households with the very lowest incomes—the current standard sets the “affordable” bar too low: the best available evidence is that typical very-low-income renters pay a lot more than 30 percent of adjusted income. If policy were set to reflect an average level of rental housing costs, the percentage would be well over 30 percent.

However, we do not like the term “affordable.” First, it has come to mean subsidized. Second, in our view, there are powerful arguments against defining “affordability” at all, at least in the context of the space between.

In the real world, each household determines what is “affordable” by its day-to-day decisions on how to spend its income. From that standpoint, the housing that any particular household occupies is de facto “affordable” simply because the household chose that housing from among the various choices that were available. It would not occur to us to criticize any particular household’s choice among the huge variety of alternatives; indeed, who but the household itself is in a position to evaluate its choices?

In the real world, households make trade-offs. A major trade-off in housing is whether to pay more for a location convenient to work, against having lower housing costs but higher transportation costs and more time spent commuting. Additionally, it is common to find that the work-convenient location has other drawbacks as well: less square footage, an older building, lower-performing public schools, greatly restricted availability of parking, more noise and congestion, and more concern for personal safety and security. Conversely, the more work-convenient location is more likely to have significant amenities within walking distance and much better access to public transportation. It would not occur to us to criticize any particular household’s choice among the various trade-offs, whether that decision is to undertake very high housing costs or to benefit from lower housing costs at the expense of a very inconvenient commute.

Similarly, it would not occur to us to criticize a household’s choice to undertake a very high housing cost burden, even if that decision seems imprudent or risky by comparison to choices made by other similar

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[15] For HUD’s definitions for income for subsidized housing programs, see 24 C.F.R. § 5. The major HUD and USDA subsidy programs use the “30 percent of adjusted income” standard for measuring affordability.

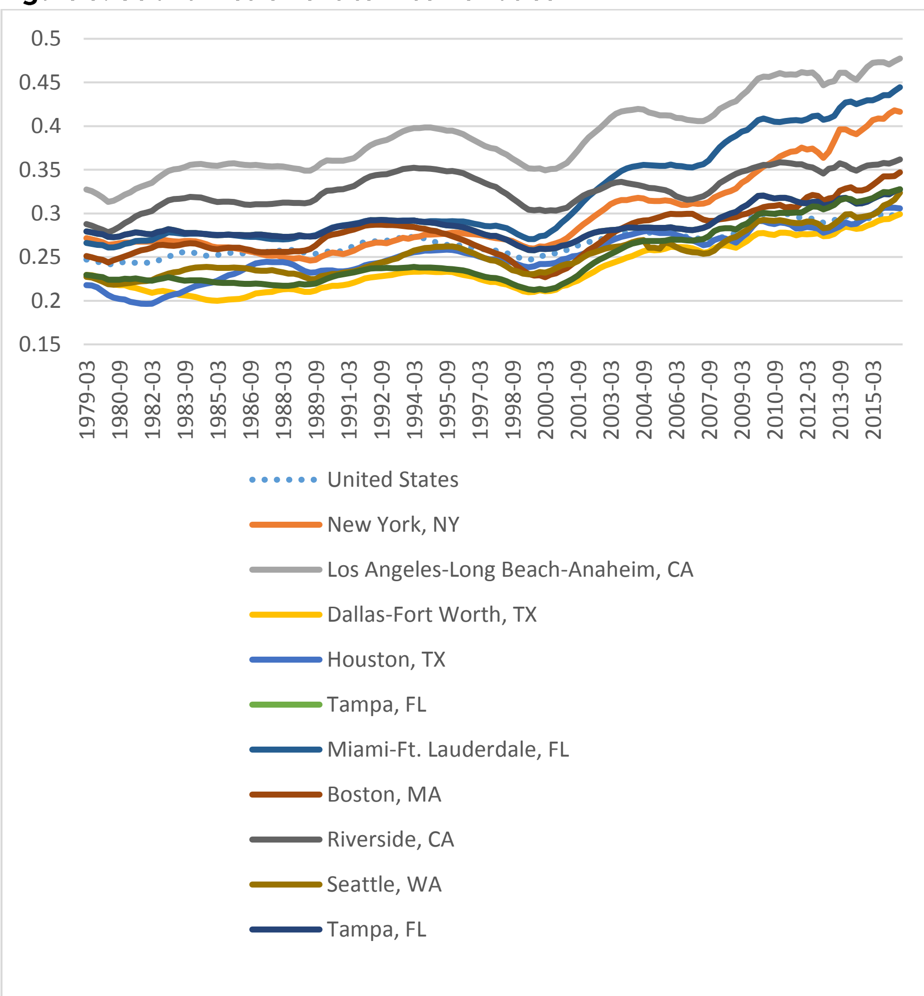
households, and even if that decision actually turns out badly, with the household being evicted because it could not, in the real world, make it choices work.

Therefore, we see no reason for public policy to favor those workforce households that choose a high-housing-cost approach over those that choose a low-housing-cost approach. Accordingly, we do not see any particular usefulness in attempting to define "affordability" in the first place—at least, not in the context of the space between. As we will demonstrate, the better policy discussion is around increasing the supply of economical apartments located near jobs.

Primer #5: Rents Have Been Rising Relative to Renter Incomes

Why This Primer Matters. You have probably heard a lot about a rental housing affordability crisis. Yes, there is one, but it is not a new phenomenon. It has been building for a long time and, as we will demonstrate in Primer #8, it is connected to land-use policies.

Figure 3. US and Metro Rent-to-Income Ratios



Source: Zillow.com research.

That said, we do recognize some usefulness in periodically measuring what is going on in the rental housing marketplace. For example, it is illuminating to see that—in recent years—rents have been rising relative to renter incomes. Many readers may think this is a recent phenomenon, related to the recent housing crisis, but it is not. Rather, it is a well-established trend dating back to at least the late 1970s.[16] Before that, miscellaneous national rent-to-income data indicate a ratio of around 20 percent, with a data point of 19 percent circa 1890.[17] As will be shown in Primer #8, there is a strong correlation between high levels of land-use restriction and lack of economical rental housing.

Primer #6: Why Have Rents Risen Faster Than Renters' Incomes?

Why This Primer Matters. It is vital that you understand that the rest of us have systematically made life difficult and expensive for workers (and consequently their employers) by imposing unreasonable requirements on developers that prevent them from building the sorts of apartments in the locations that are needed.

Why have rents risen faster than renter incomes? The fundamental answer is because we will not allow economical apartments to be built.

Since at least the 1950s, in America we have used political methods to drive up housing quality. When we make the political arguments for larger minimum unit sizes (*building codes*), smaller numbers of occupants (*occupancy codes*), smaller numbers of units per acre (*zoning codes*), and higher finish quality (*necessary, increasingly, to overcome political opposition to new development in established neighborhoods*), we pretend that our concern is about health or safety or neighborhood architectural consistency when instead the underlying concerns are about making sure new movers pay more than we paid when we moved here some years ago, make more money than we do, and are not of some different racial or ethnic background. To make things worse, new movers do not even get any political say about this—they do not live here yet, so they cannot vote here, and they have no idea that, in various public hearings and private meetings, we are driving up their future housing costs.

A side effect of this heavy-handed regulatory approach is that, typically, decisions about design and construction materials are made not by developers but by local government. Typically these local officials have a tendency to require "just one more thing," seeing only benefits and ignoring costs and unintended consequences. This is exacerbated by the fact that, in most places in America, there simply is no land on which apartments can be built as-of-right; instead, developers have to go through a long and expensive local permitting process that results in costs that are much higher than are necessary. In fact, zoning and building code and land-use restrictions are very significant barriers to creating economical rental housing, period. (For more information, see Primer #8.)

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[16] Zillow.com research, Mortgage Affordability, Rental Affordability, Price-to-Income Ratio.

[17] American Economic Association, *Report of the Proceedings of the American Economic Association,* "Housing of the Poor in American Cities," 8, no. 1 (August 23–26, 1892).

Primer #7: Adverse Side Effects of the Current Subsidy-Based Approach

Why This Primer Matters. We think that, in the context of the space between, a subsidy-based approach is a bad idea, period. Moreover, even if there were sufficient political will and funding to use subsidies to create rental housing that is economical for workers, doing so would be a bad idea.

For the moment, leave aside that in the status quo, very few workers receive *any* rental housing subsidies (and thus we have a highly inequitable system in which a few receive large subsidies while most receive none). Also, for the moment, leave aside that an entitlement to housing subsidies by workers has a political likelihood of zero.

Instead, suppose that we ignore those factors and examine the current rental housing subsidy system as a method for producing economical rental housing for workers. There are at least the following problems:

- The subsidy system is embedded in the larger system in which the development of all rental housing (both with and without subsidy) is overregulated, driving up costs.
- The subsidy system drives up costs further because the subsidies are oversubscribed, leading developers to compete on the basis of increased unit size, features, and amenities, rather than on the basis of lower costs.
- Since most of the subsidies are directly or indirectly provided by the federal government and most of the subsidy allocation decisions are made by state and local officials, controlling costs is not necessarily a high priority.
- The government officials who award the subsidies, like those who issue local approvals, tend to require "just one more thing," perceiving only benefits and ignoring costs and unintended consequences.
- Housing tends to be developed not where it is needed but where government officials want it to be developed.
- Most of the subsidy programs have eligibility rules based on household income, creating a de facto disincentive to marry and also a perverse incentive for cohabiting adults to pretend that only one of them actually occupies the unit.
- Some of the subsidy programs tie the amount of subsidy to tenants' incomes, creating a de facto work tax and marriage tax.
- Once a proposed development is designated as "affordable," or "subsidized," or "income eligible," the political path becomes more difficult, site availability more limited, and the tenant pool more constrained.
- The subsidy awards typically are not sufficient to support long-term financial and physical viability, leading to the need for future governmental bailouts and negative impacts on surrounding neighborhoods.

- Development tends to be limited to specialty developers who understand the subsidy system and who tend to not be as efficient as developers who compete in the unsubsidized markets.

In this primer, we have addressed only the subsidy system that is focused on economical housing for workers. The subsidy system for nonworkers is even more arcane, heavily regulated, and disconnected from market reality. But that is a topic for another day.

Primer #8: Planning, Zoning, Building Codes, and Other Land-Use Requirements

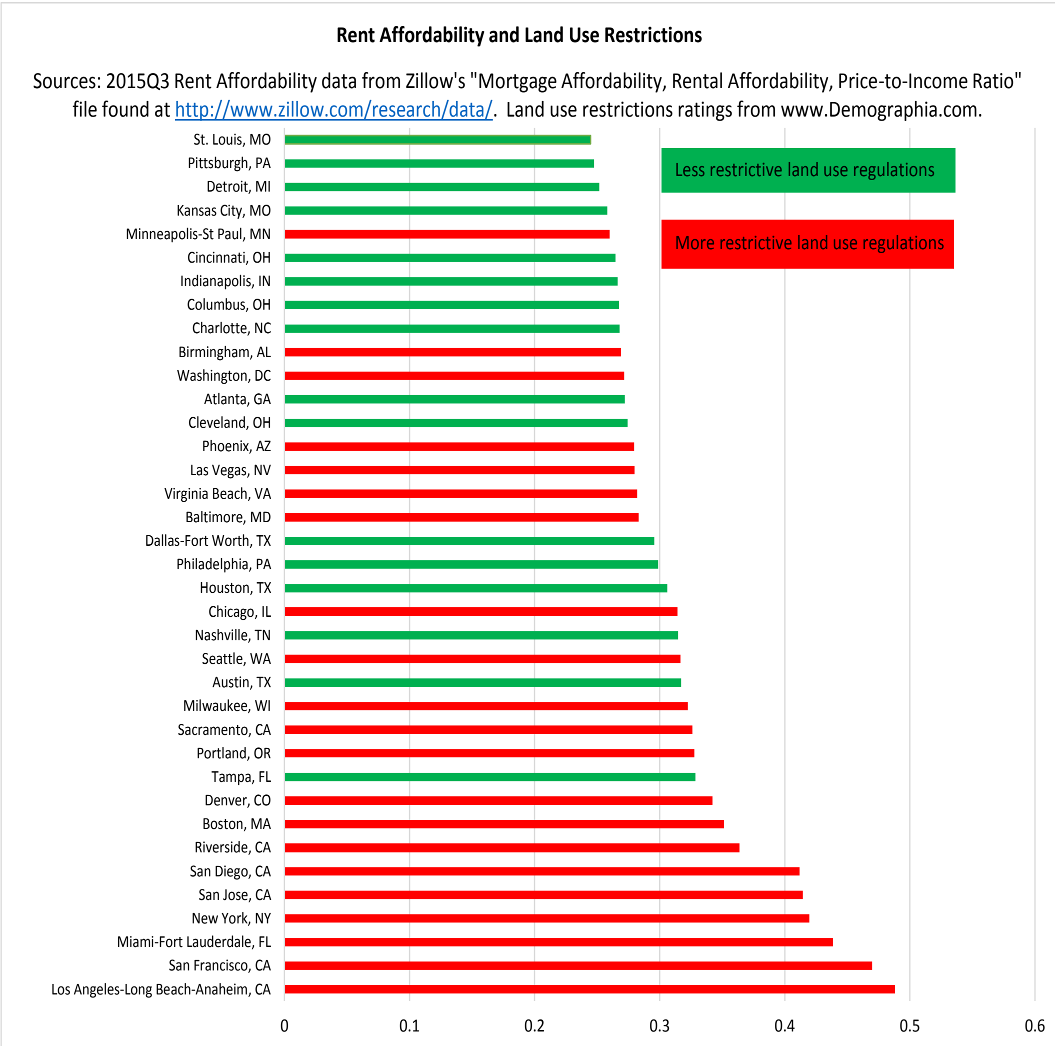
Why This Primer Matters. We have met the enemy, and he is us. Whether in the name of open space, neighborhood aesthetics, or avoiding crowding, we as voters have driven up the cost to develop housing to the detriment of workers who need economical housing, especially near where they work.

Perhaps it seems churlish to complain about "planning"—after all, isn't it always a good idea to have a plan? In real estate, however, the reality is much more complex, and the seemingly neutral label of "planning" hides a variety of underlying patterns that are among the least noble aspects of American politics.

Consider this thought experiment regarding density. A static multifamily density of say 10 units per acre creates an economic incentive in favor of higher-end 1,000-, 1,200-, and 1,600-square-foot apartments and against economical 400-, 600-, and 800-square-foot ones, since 10 units is the maximum regardless of apartment size.[18] With the supply of economical housing constricted, housing becomes less, not more, affordable. As we will note later, policies such as static densities might be replaced with equalized densities—if the maximum allowable floor area at a density of 10 units per acre is 16,000 square feet total or 1,600 square feet/unit, an equalized density of 26.7 units/acre should be allowed for 600 square foot apartments, again totaling 16,000 square feet.

[18] In 2015, the average square footage on new multifamily units built for rent was 1,109 square feet. United States Census Bureau, "Characteristics of New Housing," https://www.census.gov/construction/chars/mfu.html.

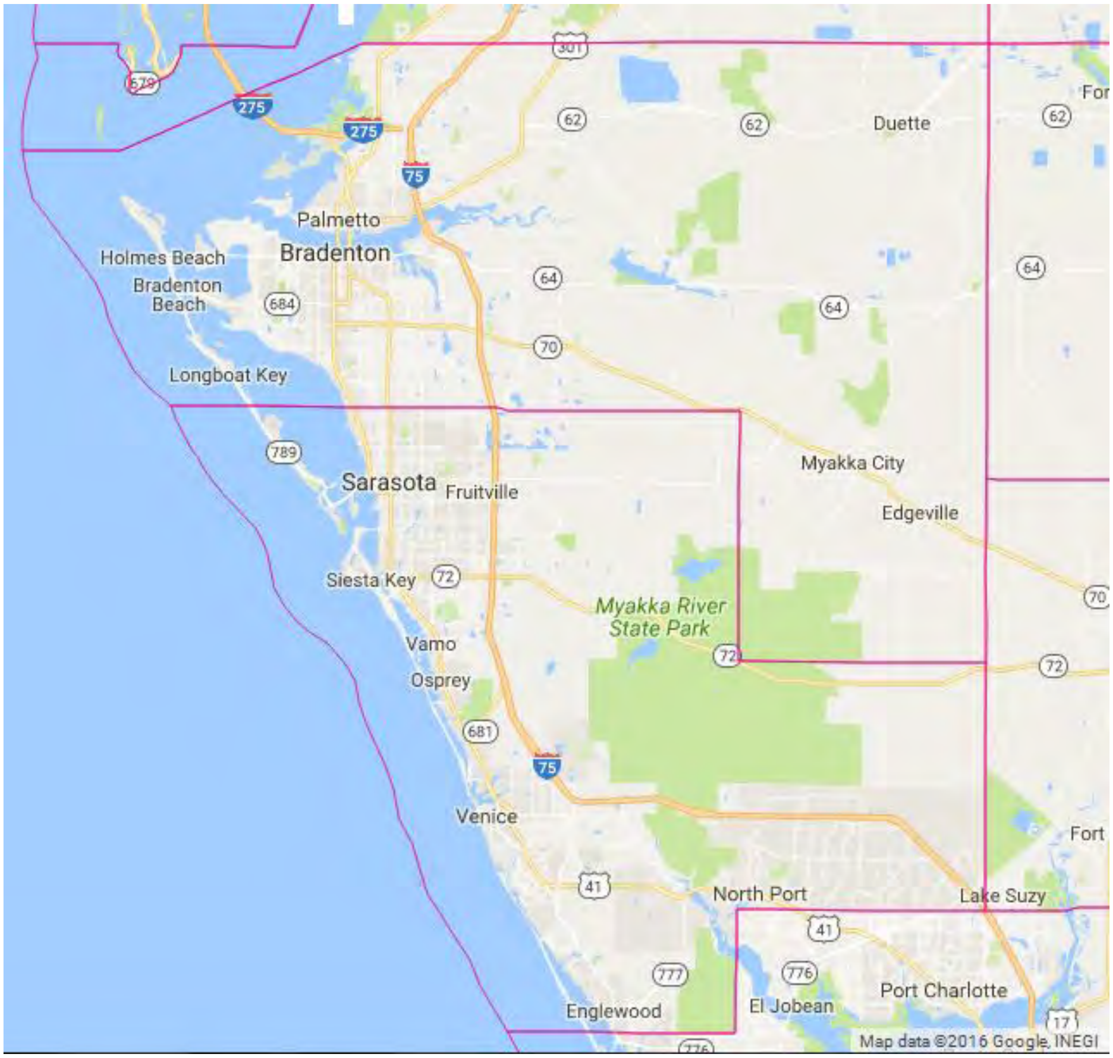
Figure 4. Rent Affordability and Land-Use Restrictions



The Sarasota-Bradenton Case Study

The North Port-Sarasota-Bradenton FL metropolitan statistical area is comprised of two counties: Sarasota (to the south) and Manatee (to the north). The total population is about 742,000, nearly evenly split between the two counties. There are four cities of note (north to south): Bradenton, Sarasota, Venice, and North Port. Seventy-five percent of the population lives in the unincorporated portions of the two counties. Service and line-production workers (wages averaging $26,000) constitute 56 percent of the total workforce—not unexpected since tourism and retirees constitute large portions of the local economy. Economical housing is scarce, particularly near concentrations of jobs.

Figure 5. Map of Sarasota



Source: http://www.mob-rule.com/g7?q=sarasota&0=Load.

Background. AEI's International Center on Housing Risk assembled a task force to research market-rate approaches for economical housing by design. The goal was to design a model with national applicability.[19] The task force focused initially on Sarasota and subsequently on the two-county area.

New construction rents in the area were $1,200+. Service and production workers could not afford those rents and were enduring very long commutes. As a result, local businesses were finding it difficult to fill positions or expand, and local entrepreneurs were finding it difficult to launch startups.

Both counties and the four largest cities had all publicly expressed concern about a lack of economical housing for service and line-production workers (56 percent of the total workforce with wages that average

[19] Initial members of the task force included Maura Corrigan (former director, Michigan Department of Human Services), Kevin Corinth (AEI economist with focus on homelessness), and the authors of this paper. Harrison Fox (expert in housing policy), Major Nathan Frizzell (Salvation Army), and Nelson and Marta Roy (architects) joined later.

about $26,000). It is against this backdrop that, in March 2016, Edward Pinto, Tom White, and other task force members began a series of 29 interviews with interested local leaders (see the Appendix for a list of interviewees). It quickly became apparent that economical rental housing—renting at $600 to $900 plus utilities—was needed; however, an online search found no apartments for rent in the downtown Sarasota area at the price points proposed. Local media had also intensely covered the topic, pointing out the barriers faced by developers that made it impossible to develop apartments with rents low enough to meet the demand from workers.[20]

The Vengroff Model. A creative developer named Harvey Vengroff built up, over a period of 14 years, a portfolio of about 1,500 market-rate economical apartments consisting of refurbished and repurposed units. These units are largely occupied by service workers with annual incomes averaging about $27,000. The task force quickly focused on the Vengroff model and the extent to which it could be expanded.

Initial Task Force Research. The study started with an in-depth evaluation of the market conditions and Vengroff's existing portfolio of 1,500 units. The study expanded to include Vengroff's plan to build 400 new, market-rate, economical apartments at a downtown Sarasota location near jobs.

Vengroff's Proposed Sarasota Project. To make the new market-rate efficiency, one-bedroom, and two-bedroom units feasible at economical rents ranging from $650 to $850 (plus utilities) would require (1) smaller, less costly units (350–715 square feet); (2) use of an exterior-walkway design; (3) a substantially reduced amount of parking in recognition that residents would own fewer cars and, given the site's central location, many residents could use mass transit, bicycles, and cars on demand; (4) greater density (50 units vs. 25 units per acre) than the city current allows; and (5) greater building height (six vs. five stories currently) than the city currently allows.

Under the City of Sarasota's existing processes, the site owned by Mr. Vengroff required amendments to the master plan, zoning, and parking requirement, plus site plan approvals by both the Planning and City Commissions. After a few years' effort, the master plan amendment was approved on May 2, 2016, by the city commission. With many hurdles yet to clear, start of construction is likely still two years off. The developer provided the authors with an estimated total development cost of $27–30 million or about $70,000 per unit, which is half or less of typical development costs.

Vengroff's Bradenton Project. As a result of widespread media coverage, other local communities took an interest and contacted the developer. Consideration of a site located in unincorporated Manatee County

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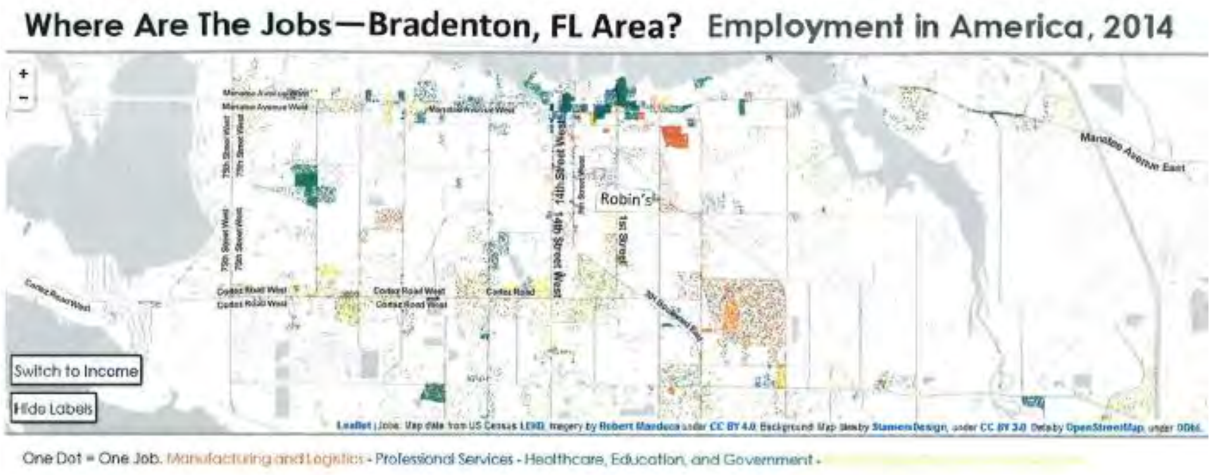
[20] Christopher Brantley, "Venice and North Port Mayors Discuss Need for Affordable Housing," MySuncoast, June 23, 2016, http://www.mysuncoast.com/news/local/venice-and-north-port-mayors-discuss-need-for-affordable-housing/article_af95590c-3989-11e6-81ff-f79d6103beb2.html; Earle Kimel, "Venice, North Port Employers Focus on Housing," *Hearld-Tribune*, June 22, 2016, http://www.heraldtribune.com/news/20160622/venice-north-port-employers-focus-on-housing; Kate Flexter, "Capacity at Former Knight's Inn Highlights Need for Affordable Housing," MySuncoast, September 5, 2016, http://www.mysuncoast.com/news/local/capacity-at-former-knight-s-inn-highlights-need-for-affordable/article_23275e48-73bd-11e6-bee9-235ebff15dc3.html; and Cooper Levey-Baker and Brad Baker, "Affordable Housing Is a Growing Crisis in Sarasota," 941CEO, September 8, 2016, https://www.941ceo.com/articles/2016/9/8/no-place-to-call-home.

(and adjacent to downtown Bradenton) began in October 2015 and quickly led to consideration of a proposal by Mr. Vengroff to repurpose and renovate a 1974 vintage 240-unit motel. The project (Robin's in Figure 6) is located near large numbers of jobs.

Figure 6. Where Are the Jobs?



An additional 120 two-bedroom units are to be newly constructed on five acres of excess land. Rents are $625 (including utilities) for the repurposed furnished efficiencies and an estimated $750 (including water but not electricity or cable) for the unfurnished two-bedroom units. For this development, the needed local flexibility entailed changing zoning to residential.

On June 2, 2016, the county commission granted the necessary approvals to proceed with the motel conversion. Renovations started in early July, and by mid-September, 120 repurposed units were occupied, with 60 more to be completed in the next two months (another 60 repurposed units continue under a prior lease pursuant to a federal contract covering farm workers until the end of 2016).

A density change is still required before proceeding with the new units. The density change is expected to be approved in the next six months, with construction to follow. Based on various press reports, the authors estimate a total development cost of $14 million for an estimated 360 units (240 refurbished and 120 new), resulting in a per-unit cost averaging about $40,000.

Recent Local Updates. In June 2016 a housing working group consisting of the mayors of Venice and North Port, the chair of the Sarasota county commissioners, two large manufacturing firms, the United Way, and others invited the Vengroff Group to participate in finding economical rental housing solutions.[21] In September 2016, Sarasota Magazine declared the developer to be "the face of affordable housing in Sarasota."[22]

Illustration of the Status Quo: Janie's III Apartments. As a counterexample of affordable housing by subsidy, the Sarasota Housing Authority and Michaels Organization recently completed a 72-unit

[21] Since August, Pinto has been attending the task force meetings.
[22] Burns et al., "Meet the 25 Most Influential Men and Women in Sarasota Today."

new-construction development, the third phase of the demolition and replacement of the 1970s-era Janie Poe public housing project.

Based on press reports, these units cost roughly $200,000 each. Of the $14.2 million total development cost, at least $12,400,000 was defrayed by at least seven different subsidy sources, with Low-Income Housing Tax Credits providing the largest share. In addition, there are 40 units with additional ongoing subsidies in the form of Section 8 payments and housing vouchers, with an estimated annual cost of $300,000 per year in total.[23]

In presenting this counterexample, we are not criticizing the housing authority or its private development partner. Rather, we think they did the best they could under a system that requires high development costs and thus a lot of subsidies to reduce the feasible rents. We argue that, instead of continuing existing requirements that result in development costs of $200,000 per unit, the locality should adopt the sorts of changes we suggest in this paper, leading to per-unit development costs well below $100,000, without the need for subsidies.

State and Local Government Toolkit

We suggest these steps for increasing the supply of new construction (or adaptive reuse) economical apartment units designed to serve service, production, and entry-level workers:

1) Find that increasing the supply of market-rate economical housing by design is in the public interest.
2) Declare that land use and building ordinances are to be liberally and flexibly construed to increase the supply of market-rate, economical housing so long as construction will not be adverse to the public health, safety, or welfare.
3) Direct staff, to the maximum extent feasible, to assist in accommodating market-rate, economical housing.
4) Reduced parking requirements for economical rental housing developments to recognize reduced dependence on cars.
5) Use density bonuses for economical rental housing developments.
6) Where appropriate, provide relief from otherwise applicable building height restrictions for economical rental housing developments.
7) Consider an equalized approach to density (regulate square feet per acre, not units per acre). For example, using a static density limit of 10 units per acre encourages larger units and higher rents, whereas allowing 12,000 square feet per acre would allow developers to produce 20 units at 600 square feet instead of 10 units at 1,200 square feet.

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[23] Caitlin Ostroff, "Janie's Garden Is Complete with Grand Opening Ceremony," *Herald-Tribune*, July 27, 2016, http://www.heraldtribune.com/news/20160727/janies-garden-is-complete-with-grand-opening-ceremony; and "Sarasota Housing Authority, the Michaels Organization Celebrate Grand Opening of Janie's Garden Phase III," Erie News Now, July 27, 2016, http://www.erienewsnow.com/story/32556630/sarasota-housing-authority-the-michaels-organization-celebrate-grand-opening-of-janies-garden-phase-iii.

8) Expedite or fast track planning, zoning, PUD, plan and architectural review, permitting, and variance approvals for economical rental housing developments.

9) Allow just-in-time inspections for economical rental housing developments. Implement a process for economical housing whereby a code or building inspection request by, say, 10:00 a.m. is fulfilled the same day.

10) Reduce fees to recognize the public-mission value of providing economical rental housing.

11) Direct staff to exercise flexibility and expedite appeals, whenever literal code requirements are burdensome and a substantially equivalent approach is more economical, for economical rental housing developments.

Additionally, for repurposed and refurbished buildings for economical rental housing:

1) Establish a "good enough" standard for code compliance. Code variances should be permitted if the facts demonstrate compliance with the literal code provision(s) will impose an undue economic hardship relative to achieving such repurposing or refurbishing. Such variance may either provide for noncompliance with the rule or compliance with an alternative requirement so long as such variance will not be adverse to the public health, safety, or welfare. There should be a presumption in favor of waiving requirements to meet current standards, where prior standards are still grandfathered for existing buildings. For example:
    a) Not requiring window replacement, when existing windows are reasonably serviceable and reasonably efficient.
    b) Not requiring resizing doorways.
    c) Not requiring addition of sprinklers where the unit has smoke detectors and exits directly to the outside.
2) Establish a "substantial equivalence" standard for change of use: where the new use (e.g., rental apartments) is substantially equivalent to the prior use (e.g., a motel), permit the new use without requiring a new approval process and without requiring fees as if new construction were taking place.

Conclusion: Bend the Cost Curve to Allow Private Developers to Meet Demand from Workers for Economical Rental Housing—Without Subsidies

Lower costs resulting from flexible and reduced regulations will allow the rental housing market to work roughly the same way the markets for cars and hotels work—in response to supply and demand. Lower costs will:

- Expand the pool of potential developers;
- Eliminate the constraint of competing for limited subsidies;

- Allow supply to expand more rapidly;
- Allow supply and demand to reach equilibrium at lower rents;
- Primary benefit service, light manufacturing, and entry-level workers, workers who are moderate-income and increasingly minority; and
- Will also benefit local employers and the local economy.

Localities that adopt the approaches suggested in this paper will release the creativity of developers, allowing them to build market-rate, unsubsidized properties with much lower rents than can be achieved in the status quo. We hope this paper stimulates broad experimentation with these creative approaches.

About the Authors

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Edward J. Pinto (edward.pinto@aei.org) is a resident fellow at AEI and codirector of AEI's International Center on Housing Risk. He is also the former senior vice president for marketing and product management (included multifamily) and executive vice president and chief credit officer for Fannie Mae.

Appendix: Sarasota-Bradenton Case Study Interviews

For the Sarasota-Bradenton case study, we interviewed or met with the following individuals:

Wayne Applebee, director of homeless services, Sarasota County
Maryse Awad, property manager, Vengroff-Williams Inc.
Thomas Barwin, city manager, City of Sarasota
Susan Chapman, commissioner, City of Sarasota
Robin DiSabitino, commissioner, Manatee County
Audrey Duran, property manager, Vengroff-Williams Inc.
Shelli Eddie, commissioner, City of Sarasota
Harrison Fox, PhD., Florida housing expert
Major Ethan Frizzell, Salvation Army
David Gustafson, former planner, City of Bradenton and Manatee County
John Holic, mayor, City of Venice
Amy Jones, Salvation Army
Debbie LaPinska, PGT Industries
Alicia Larkins, Tervis Company
Brian Lichterman, former planner, Sarasota County
Douglas Logan, former director, homelessness, City of Sarasota
Alan Maio, chair, board of commissioner, County of Sarasota
Jacqueline Moore, mayor, City of Northport
Tobin Page, property manager for a Vengroff-Williams Inc.
Chris Panichello, retired police officer, City of Sarasota
Erika Quartermaine, court judge, Sarasota
Marta Roy, architect
Nelson Roy, architect
Kevin Stiff, police captain, City of Sarasota
Maryann Terry, United Way South Sarasota County
Jon Thaxton, Gulf Coast Community Foundation; former commissioner, Sarasota County
Harvey Vengroff, Vengroff-Williams Inc.
Travis Vengroff, Vengroff-Williams Inc.
Bill Wilson, Resurrection House