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Factors that May Limit the Production of Affordable Housing

SUMMARY

Recently, considerable attention has been given to factors that potentially limit the production of affordable housing. Producers of housing assess these factors differently, depending on their role in producing housing. Developers emphasize land use and zoning restrictions, while local housing organizations emphasize financing problems. However, almost everyone agrees that the cost of land, labor, and materials—particularly land—limits the production of affordable housing. Many of the potential impediments were created for valid policy reasons. For example, while building code standards may add to the cost of housing, the code ensures that housing is safe and well constructed. Consequently, efforts to address these factors will require policy makers to balance competing policy objectives.

After the federal Advisory Commission on Regulatory Barriers to Affordable Housing released a report in 1991, the issue of government policies and other factors that potentially limit the production of affordable housing received new attention. In creating the Commission, then President Bush observed:

> [At] all levels of government, we have got to take a second look at some of the well-intended housing policies that actually decrease our housing supply. I'm talking about the excessive rules, regulations, and red tape that add unnecessarily to the cost of housing – by tens of thousands of dollars…[1]

In response, the United States Department of Housing and Urban Development issued a guide in 1994 for states to assess these factors in their states.[2] Based on these and other reports and interviews with Minnesota housing experts, we tried to create a comprehensive list of factors that might impede the production of affordable housing in Minnesota. This chapter addresses the following question:

- **According to the people who produce housing in Minnesota, how significant are the various factors that may limit the production of affordable housing?**

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1 Advisory Commission on Regulatory Barriers to Affordable Housing, *"Not In My Back Yard," Removing Barriers to Affordable Housing* (Washington DC: United States Department of Housing and Urban Development, 1991), 1.

2 Council of State Community Development Agencies and the National Conference of States on Building Codes & Standards, *Making Housing Affordable: Breaking Down Regulatory Barriers, A Self-Assessment Guide for States* (Washington DC: United States Department of Housing and Urban Development, March 1994).

We sent surveys to 1,106 developers, builders, and local housing organizations.

To answer this question, we took a two-step approach. First, we sent surveys to 1,106 land developers, builders, companies that both develop and build, and local housing organizations. (Local housing organizations are public and nonprofit agencies that work to provide affordable housing.) We used mailing lists from the Minnesota Housing Finance Agency and several trade associations to identify these organizations. We received surveys from 613 of these organizations but only analyzed the surveys from the 439 that produced at least one housing unit in 1999. Appendix A provides more details about our survey methodology. Second, realizing that many of these survey respondents express subjective opinions, we conducted interviews and obtained information from other studies and data sources to assess and qualify the survey results.

Overall, our survey results show that:

- **Although there is otherwise little consensus about what factors significantly limit the production of affordable housing, all four types of organizations that we surveyed agreed that the cost of land, labor, and materials – particularly land – is a significant limitation.**

Tables 2.1 and 2.2 show how the survey groups assessed the significance of each factor. The variation in survey responses reflects each group's role in producing affordable housing. Land developers acquire land and prepare it for residential use by subdividing the parcel into lots, grading the site, and installing infrastructure, such as water and sewer lines and streets. Consequently, they were most concerned about land use policies, such as zoning and subdivision ordinances, growth management policies, and wetland regulations. Builders ranked the building and fire codes relatively high because these codes dictate how they build housing. Finally, local housing organizations were primarily concerned with financing issues because they play a major role in financing many affordable housing projects. However, federal, state, and local governments created many of these factors to achieve valid policy objectives. For example, while building permit fees increase the cost of housing, municipalities use the revenue to enforce the building code. In the following sections, we discuss the survey results for these factors in more detail, along with other data and information.

COST OF LAND, LABOR, AND MATERIALS

Land, labor, and materials are the primary components of constructing housing, and their costs are heavily influenced by market forces outside governments' direct control. A tight labor market drives up labor costs; a construction boom increases the demand and price for lumber, concrete, and drywall; and a desire to live in growing, vibrant communities increases the demand and price for land. At the same time, government policies can affect these costs, particularly land costs. For example, zoning and subdivision ordinances and growth management policies can limit the supply of land available for residential development and consequently inflate prices.

Of all the factors shown in Tables 2.1 and 2.2, the cost of land, labor, and materials is the only factor that a majority of respondents from all four survey groups identified as a significant limitation. While we did not ask survey

Table 2.1: Ranking of Impediments to Single-Family Housing by Type of Organization

	More Frequently Cited Impediments Receive More Stars			
	Developers (*N* = 30)	Developers/ Builders (*N* = 87)	Builders (*N* =138)	Local Housing Organizations (*N* = 118)
Cost of labor, materials, or land	****	****	***	***
Local zoning or subdivision ordinances or development standards	***	***	**	*
Land-use policies other than local zoning or subdivision ordinances	***	***	*	*
Development or construction fees	***	***	**	**
Standards from the state building or fire codes	**	***	**	*
Financing issues	*	**	*	***
Taxes	*	**	*	*
Reaction from the community	**	**	*	*
Other government policies or programs	**	**	*	*

NOTE: We asked survey respondents to "indicate the extent to which each of the factors listed … limits the production of affordable single-family housing in Minnesota." We provided four possible options: (1) does not limit production, (2) limits production marginally, (3) limits production significantly, and (4) don't know.

**** 75 to 100 percent of respondents indicated "limits production significantly."
*** 50 to 74 percent of respondents indicated "limits production significantly."
** 25 to 49 percent of respondents indicated "limits production significantly."
* 0 to 24 percent of respondents indicated "limits production significantly."

Rankings only include respondents who produced at least one single-family unit in 1999.

SOURCE: Office of the Legislative Auditor's survey of developers, builders, and local housing organizations, July and August 2000.

Respondents pointed to land costs as an especially significant factor that limits the production of affordable housing.

respondents to evaluate land, labor, and materials costs separately, two pieces of information suggest that land is particularly important. First, when we asked respondents to provide specific examples of how the cost of land, labor, and materials limits the production of affordable housing, they cited land the most often, as shown in Figure 2.1.[3] For example, a company that develops land and builds housing stated, "Land has at LEAST doubled in cost over the last 5 years (emphasis in original)." Second, when we asked developers and builders that did not produce affordable housing in 1999 why they did not, those involved in multifamily housing cited land costs the most often, while those involved in single-family housing cited land only slightly less frequently than general responses, such as "we don't produce houses in that price range."[4]

3 Each survey group by itself cited land the most often. In some cases, land was tied with labor costs.

4 Office of the Legislative Auditor's survey of developers and builders, July and August 2000.

Table 2.2: Ranking of Impediments to Multifamily Housing by Type of Organization

	More Frequently Cited Impediments Receive More Stars			
	Developers (*N*= 35)	Developers/ Builders (*N*= 48)	Builders (*N*= 22)	Local Housing Organizations (*N*= 83)
Cost of labor, materials, or land	***	***	***	***
Local zoning or subdivision ordinances or development standards	***	****	**	**
Land-use policies other than local zoning or subdivision ordinances	***	***	**	*
Development or construction fees	**	***	**	**
Standards from the state building or fire codes	**	***	**	*
Financing issues	***	**	*	***
Taxes	***	**	**	**
Reaction from the community	****	***	**	***
Other government policies or programs	***	**	*	**

NOTE: We asked survey respondents to "indicate the extent to which each of the factors listed … limits the production of affordable multifamily housing in Minnesota." We provided four possible options: (1) does not limit production, (2) limits production marginally, (3) limits production significantly, and (4) don't know.

**** 75 to 100 percent of respondents indicated "limits production significantly."
*** 50 to 74 percent of respondents indicated "limits production significantly."
** 25 to 49 percent of respondents indicated "limits production significantly."
* 0 to 24 percent of respondents indicated "limits production significantly."

Rankings only include respondents who produced at least one multifamily unit in 1999.

SOURCE: Office of the Legislative Auditor's survey of developers, builders, and local housing organizations, July and August 2000.

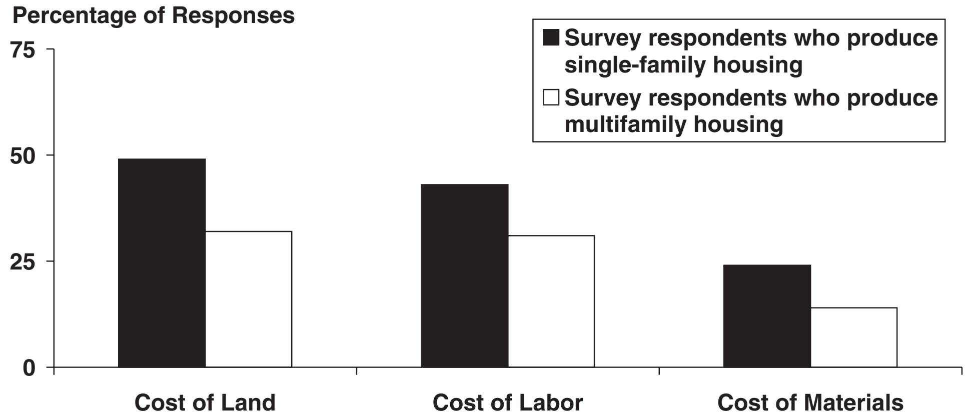
Data suggest that the costs of land, labor, and materials have increased substantially over the last five years.

We found only limited data on how much land, labor, and material costs have increased in recent years. Consequently, we can only provide limited examples. According to the RS Means Company (a publisher of construction data), the combined cost of labor and materials increased 17 to 24 percent in Minneapolis, Rochester, and Duluth between 1995 and 2000.[5] In the same three cities, the cost of skilled trade labor increased 20 to 36 percent.[6] In addition, there are no statewide data on the cost of developed lots—those with infrastructure, such as streets and water and sewer lines. The Hennepin County Assessor's Department examined the sales price of developed lots in five growing suburbs (Brooklyn Park, Champlin, Eden Prairie, Maple Grove, and Plymouth) and found that

5 RS Means Company Inc., *Means Construction Cost Indexes,* 26, no. 1 (January 2000), 34.

6 RS Means Company Inc., *Labor Rates for the Construction Industry, 22nd Annual Edition* (Kingston Massachusetts: RS Means Company Inc., 1994), 139-142; and RS Means Company Inc., *Labor Rates for the Construction Industry, 27th Annual Edition* (Kingston Massachusetts: RS Means Company Inc., 1999), 139-142.

Figure 2.1: Percentage of Respondents who Cited Various Housing Cost Components as an Impediment



NOTE: We asked survey respondents who identified the cost of land, labor, or materials as a marginal or significant impediment to provide at least one example. This graph shows the percentage of respondents who reported each housing component as an example. Due to our sampling method, we are unable to provide a precise margin of error for each response rate. See Appendix A. *N* = 209 for organizations producing single-family housing and 94 for organizations producing multifamily housing.

SOURCE: Office of the Legislative Auditor's survey of developers, builders, and local housing organizations, July and August 2000.

average prices increased 22 to 53 percent between 1995 and 2000.[7] The Olmsted County Assessor did a similar analysis and found that prices increased 38 percent in Rochester and about 65 percent in Byron and Stewartville during this period.[8] During these years, the consumer price index increased only 13 percent.[9]

ZONING AND SUBDIVISION ORDINANCES AND DEVELOPMENT STANDARDS

Local governments direct how land is developed through zoning and subdivision ordinances. Zoning ordinances determine (1) the density and distribution of a community's population, (2) the uses of land and buildings, (3) the location and size of buildings, (4) the percentage of a lot that may be occupied by buildings or structures, and (5) the size of yards and other open spaces.[10] Subdivision ordinances determine how undeveloped land is subdivided and platted by

7 Hennepin County Assessor's Department, table titled "Residential Single Family Detached Land Sales," undated.

8 Olmsted County Assessor, table titled "Residential Single Family Detached Land Sales," undated. The Olmsted County Assessor provided more detail about his estimates. For each city and year, the average sale price is only based on three to nine sales. The Rochester sales occurred in the North Park subdivisions. In addition, between 1995 and 2000, the average lot size increased by 28 percent in Bryon and less than 1 percent in Rochester, but declined by 15 percent in Stewartville.

9 United States Bureau of Labor Statistics, *Consumer Price Index – All Urban Consumers*, http://146.142.24/cgi-bin/surveymost; accessed October 25, 2000. Because the annual price index for 2000 was not available, we used price indices for July of 1995 and 2000.

10 *Minn. Stat*. (2000) §462.357, subd. 1.

regulating (1) site planning and (2) the size, location, and improvement of lots, streets, curbs, utilities, and other infrastructure.[11] Local governments use zoning and subdivision ordinances to carry out their comprehensive plans, which guide the physical, social, and economic development of a community.[12] In addition, local governments use development standards in ordinances to control how housing is built. For example, some cities require single-family homes to have two enclosed garage spaces.

In our survey (see Tables 2.1 and 2.2),

- **Developers consistently indicated that zoning and subdivision ordinances significantly limit the production of affordable housing.**

When we asked them to provide specific examples, a little over half of the developers commented on (1) land being zoned for low densities or large lots or (2) a lack of land made available for residential development. For example, one developer stated, "Restrictions on lot sizes and density result in bigger and costlier units, and less of them. This drives up the cost of housing." Another developer commented, "[There is a] lack of land zoned for multifamily property in every metro county. There are very few vocal local city officials who will promote multifamily development." In general, builders indicated less often than developers that local ordinances were a problem, but when they did report a problem, they frequently cited development standards. For example, one builder wrote in his survey, "Ordinances set down rules for [the] square footage, roof pitch, [and] exterior finish…[of homes]." [13]

Zoning and subdivision ordinances affect the price of developed lots because they control how much land is available for residential development and determine the density at which development occurs. The cost of a developed lot is a major component of the overall price of a home. The building industry generally estimates that the cost of a developed lot accounts for about 25 percent of a single-family home's value.[14] The percentage for multifamily housing is less.

Housing in higher density developments is generally less expensive.

One of the simplest ways to reduce the cost of a developed lot is to divide it in half and create two lots. While doubling a development's density will reduce lot costs significantly, it will not cut costs in half for two reasons. First, as density increases, the overall value of the land increases, which partially offsets savings from developing smaller lots. According to land developers that we interviewed, undeveloped land that is zoned for four units per acre is generally more valuable than an equivalent piece of land zoned for two units per acre. Second, while higher density development requires less infrastructure (streets and water and sewer lines) per lot, the cost is not cut in half by doubling the density. Using actual cost information for a metropolitan community, the Builders Association of the Twin Cities calculated that infrastructure costs and fees associated with

11 *Minn. Stat*. (2000) §462.358, subd. 1 - 2(a).

12 *Minn. Stat*. (2000) §462.352.

13 Office of the Legislative Auditor's survey of developers and builders, July and August 2000.

14 Interviews with several housing experts.

In some areas, zoning ordinances allow apartments above commercial space.

developing single-family lots declined 50 percent when the development's density more than doubled (increasing 144 percent from 1.6 units per acre to 3.9).[15]

In theory, the state can control local government's land use decisions and require them to zone for small lots to accommodate affordable housing. However, when reviewing state statutes, we found that:

- **Minnesota gives local governments considerable discretion in determining how their communities develop, including if and how they accommodate affordable housing.**

The state encourages communities to accommodate affordable housing in their zoning and subdivision ordinances.

The state encourages local governments to accommodate affordable housing by implementing policies consistent with the goals of the Community-Based Planning Act of 1997, which include developing and preserving affordable housing throughout the state.[16] In addition, statutes say that promoting "the availability of housing affordable to persons and families of all income levels" is a primary objective of subdivision ordinances.[17]

Land use planning in the seven-county Twin Cities area is more formal than it is in outstate because the Metropolitan Council reviews all local comprehensive plans. As mentioned earlier, comprehensive plans guide the physical, social, and economic development of a community through zoning and subdivision

15 Builders Association of the Twin Cities, *Fees, Infrastructure Costs, and Density…Their Impact Upon the Twin Cities' Regional Growth Strategy & Life-Cycle Housing Goals* (Roseville, MN: Builders Association of the Twin Cities, 2000), appendix tables. The analysis applies to City B when switching from plat #1 to plat #2.

16 *Minn. Stat.* (2000) §394.232, subd. 1 and §462.3535, subd. 1.

17 *Minn. Stat.* (2000) §462.358, subd. 1a.

ordinances and other policies. The Metropolitan Council is the regional planning agency and develops affordable housing policies and goals. Under state law, metropolitan communities must include housing and implementation elements in their comprehensive plans that promote the development of low- and moderate-income housing and meet the community's share of the region's need for affordable housing.[18] While the Council reviews these plans, it lacks the legal authority to require communities to comply with the Council's housing policies and goals.[19]

Land use planning in the Twin Cities area is more formal than it is in outstate Minnesota.

Because Twin Cities area communities have significant control over their land use decisions, we found that:

- **Land use patterns vary significantly across the Twin Cities metropolitan area, even among developing suburbs.**

We analyzed the Metropolitan Council's land use data, focusing on the region's 63 developing suburbs because the Council estimates that 64 percent of the region's household growth between 2000 and 2020 will occur in these communities.[20] Therefore, land use policies and patterns of the developing suburbs will largely dictate how the region grows over the next 20 years. As discussed previously, developers contend that zoning and subdivision ordinances that restrict high-density developments significantly limit the production of affordable housing.

Residential land use patterns in the developing suburbs vary in three ways – single-family densities, multifamily densities, and the percentage of land used for multifamily housing.

- Single-family densities ranged from 3.2 units per acre in Osseo to 0.5 in Woodland in 1990.[21]

- Multifamily housing densities ranged from 42 units per acre in Osseo to 1.1 in Deephaven in 1990.[22]

- The percentage of residential land used for multifamily housing in 1997 ranged from 34 percent in Spring Park to 0 percent in Woodland, Sunfish Lake, Pine Springs, Minnetonka Beach, and Birchwood Village.[23]

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18 *Minn. Stat.* (2000) §473.859, subd. 2 and 4; §473.86; and §473.861.

19 According to Metropolitan Council staff, they cannot require compliance with their housing goals because housing is not a metropolitan system, which includes sewer, transportation, recreation, and aviation services. Under *Minn. Stat.* (2000) §473.175, subd. 1, "The council may require a local government unit to modify any comprehensive plan or part thereof which may have a substantial impact on or contain a substantial departure from metropolitan system plans."

20 Metropolitan Council, spreadsheet titled "Metro Council 2000 Household Forecast Comparisons," received November 28, 2000.

21 Metropolitan Council, unpublished table titled "Residential Density by County," undated. Landfall, a developing suburb in Washington County, has a density of 8.5 units per acre for single-family homes. It is excluded from the comparison because the entire municipality is only 53 acres.

22 *Ibid.*

23 Metropolitan Council, "Metropolitan Council Geographic Systems," http://www.metrocouncil.org/metroarea/gismain.htm; accessed September 14, 2000.

The cities of Chaska and Victoria provide an interesting example of varying land use in the developing suburbs. The two communities are adjacent developing suburbs in the southwestern part of the metropolitan region. They share a school district and are both on the edge of urban development, with the border of the metropolitan urban services area (the area in which the Metropolitan Council provides urban services) cutting through them. Despite these similarities, the two cities have very different development patterns and types of housing. As shown in Table 2.3, Chaska has higher single-family and multifamily densities and more multifamily and affordable housing.

Zoning policies helped create these land use patterns. Chaska is an older freestanding community with a mix of residential, commercial, and industrial development that originally developed single-family lots as small as 7,200 square feet. However, under current zoning policies, new single-family lots must be at least 11,500 square feet.[24] In contrast, Victoria is a relatively new bedroom

The cities of Chaska and Victoria have developed very differently.

Table 2.3: Land Use and Zoning Information from Chaska and Victoria

	Chaska	Victoria
Land Uses in 1997 (Acres)[a]		
Single-family housing	1,634	750
Multifamily housing	174	22
Commercial	139	15
Industrial	568	8
Public or recreational	1,612	1,556
Vacant or agricultural	3,887	1,689
Other	1,182	1,429
Total	9,196	5,469
Housing Densities in 1990 (Units per Acre)[b]		
Single-family	2.6	1.1
Multifamily	8.9	3.7
Affordable Housing Measures[c] — Percentage of:		
Owner occupied homes that are affordable	75%	39%
Rental housing that is affordable	49	52
The housing stock that is multifamily	49	13
The housing stock that is rental	31	11
Requirements in the City's Highest Density Zoning District for Single-Family Homes[d]		
Minimum lot size (square feet)	7,200	15,000
Minimum number of covered garage spaces	0	2

SOURCES: As specified in the following footnotes.

[a]Metropolitan Council, "Metropolitan Council Geographic Systems," http://www.metrocouncil.org/metroarea/gismain.htm; accessed on September 14, 2000.

[b]Metropolitan Council, unpublished table titled "Residential Density by County," undated.

[c]Metropolitan Council, *Report to the Minnesota Legislature on Affordable and Life-Cycle Housing in the Metropolitan Area* (St. Paul, December 1999), Appendix 2. The information is based on data from 1990 and 1994.

[d]Cities of Chaska and Victoria. The minimum lot size for new homes in Chaska is now 11,500 square feet.

24 City of Chaska Planning Department.

community. Its smallest standard single-family lots are 15,000 square feet.[25] In addition to smaller lots, Chaska does not require garages in its highest-density, single-family zoning district, while Victoria requires two enclosed garages per home in its highest-density district.

State statutes protect individual property owners from zoning changes in their neighborhoods.

Besides giving communities considerable control over their land use decisions, Minnesota protects individual property owners from zoning changes in their neighborhoods. To increase housing density and accommodate affordable housing, developers and local housing organizations sometimes ask city councils to rezone land. Rezoning can be difficult for two reasons. First, state statute requires that two-thirds of a city council, rather than a simple majority, agree to adopt or revise a zoning ordinance.[26] As we discuss later in this chapter, zoning changes to provide affordable housing can be very contentious. Getting four members of a five-person city council or five members of a seven-person council to agree can be very difficult. Second, in cities of the first class (Duluth, Minneapolis, and St. Paul), state statute requires that two-thirds of the property owners within 100 feet of the property being rezoned consent to the change if less than 40 acres are rezoned.[27] While these three cities can preempt this requirement by providing an alternative procedure in their home rule charters, none of the cities have done so.

State requirements limiting zoning changes serve a valid function. Land use decisions can last generations, while political power and influence may only last a few years. According to zoning experts that we interviewed, these requirements are intended to protect the rights of property owners from the ebb and flow of political philosophy and power. However, the policies make it difficult to rezone land for smaller lots and multifamily housing. Consequently, in a recent affordable housing report, a group of Twin Cities area mayors called for the repeal of these provisions.[28]

OTHER LAND USE POLICIES

As shown earlier in Tables 2.1 and 2.2, according to our survey:

- **Other land use policies—such as environmental regulations and the Metropolitan Council's management of the metropolitan urban services area (MUSA)—are a major concern primarily of developers.**[29]

For example, one developer stated, "Wetland preservation requirements have become too onerous. Preserving small isolated wetlands is expensive and illogical." With respect to the MUSA, another developer commented, "[The] MUSA line has created an artificial shortage of land."

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25 City of Victoria Planning Department.

26 *Minn. Stat.* (2000) §462.357, subd. 2.

27 *Minn. Stat.* (2000) §462.357, subd. 5. If two-thirds of the property owners within a 100 feet consent, the city council can adopt the amendment with only a simple majority.

28 Mayors' Regional Housing Task Force, *Affordable Housing for the Region: Strategies for Building Strong Communities* (St. Paul: Metropolitan Council, November 2000), 18.

29 Office of the Legislative Auditor's survey of developers and builders, July and August 2000.

Because of time constraints, we did not examine the effect that environmental regulations have on affordable housing. However, wetland preservation is another good example of an important public policy that may have adverse effects on the production of affordable housing.

But, we did examine the Metropolitan Council's MUSA policy because it was a topic of considerable debate during the fall of 2000. The Metropolitan Council's Housing and Land Use Advisory Committee made this issue the centerpiece of its fall meetings, and the Builders Association of the Twin Cities recently released a high profile report on the issue.

Metropolitan Urban Services Area

The Metropolitan Council tries to facilitate orderly and compact development.

The MUSA is the area in the seven-county Twin Cities region where the Metropolitan Council provides infrastructure—primarily wastewater treatment facilities and transit—to serve urban development. The Metropolitan Council's MUSA policy is intended to: (1) provide sufficient land to accommodate future development and redevelopment, (2) manage the cost of providing public services, (3) encourage efficient use of land, (4) prevent artificial increases in land prices, (5) meet future affordable and other housing needs, (6) protect resources, and (7) support regional economic competitiveness.[30] To achieve its MUSA goals, the Council's staff forecasts household and employment growth through 2020 and then allocates the new households and jobs to each of the region's 188 municipalities. Municipalities provide feedback, and the Council and municipalities work to resolve any forecast differences. Finally, the Council and municipalities use the projections to determine how, when, and where to add land to the MUSA.[31] Municipalities on the edge of the MUSA develop plans, under the review of the Council, to accommodate the expected growth through staged expansions of the MUSA through 2020.[32]

To ensure that the MUSA policy does not inflate land prices by significantly restricting the supply of land, the MUSA is expanded when the supply of developable land drops below a 10-year supply. The Council currently allows development within the MUSA designated for 2010, assuming regional infrastructure is available. However, the Builders Association of the Twin Cities contends that the Council's estimates of developable land are flawed. For example, the Council estimated that 97,000 acres within the 2000 MUSA were vacant or agricultural land, and the Builders Association believes this estimate overstated the amount land available for development. According to a recent study by the Builders Association, no more than 43 percent of the vacant and agricultural land was potentially available. The analysis identified various types of land that were not available for future development, including (1) conservation

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30 Metropolitan Council, *Regional Blueprint* (St. Paul, December 1996), p. 49; and Metropolitan Council staff presentation to the Council's Housing and Land Use Advisory Committee, September 14, 2000.

31 *Minn. Stat*. (2000) §462.352, subd. 18 defines an urban growth area as an "area around an urban area within which there is a sufficient supply of developable land for at least a prospective 20-year period, based on demographic forecasts and the time reasonably required to effectively provide municipal services to the identified area."

32 Metropolitan Council staff presentation to the Council's Housing and Land Use Advisory Committee, September 14, 2000.

easements, (2) areas of current residential development, (3) areas planned for commercial, office, and industrial development, (4) park and recreational areas, (5) institutional- and city-owned properties, (6) buffer zones, (7) land fills, and (8) overhead easements. In a follow-up analysis, the Builders Association plans to identify additional land that is not available for development, including floodplains, steep slopes, and areas with poor soil.[33]

How much land is available for development in the Twin Cities area is a subject of considerable debate.

In estimating that there were 97,000 acres of vacant and agricultural land within the 2000 MUSA, the Council conducted a land inventory but not an assessment of which acres were actually developable. Consequently, the Council also does not believe that all 97,000 acres were developable. The Council bases its determination of how much land is developable primarily on input from localities during the planning process. According to local planning documents, municipalities intend to develop 42,000 acres within the 2000 MUSA. In addition, municipalities identified another 58,000 acres for development in MUSA expansions through 2020.[34]

After reviewing the literature about this issue, we found that:

- **Although the price of land is a major issue in the region, evidence that the Metropolitan Council's MUSA policy significantly inflates the price is inconclusive.**

Since 1995, several studies by the Metropolitan Council and the Builders Association of the Twin Cities have examined the impact of the Council's MUSA policy on land prices.[35] All of the studies found that land inside the MUSA is generally more expensive than land outside the area. However, the studies differ with respect to the size and cause of the difference.

The Builders Association contends that the Council's MUSA policy is too restrictive and has led to a "serious shortage" of land available for development and inflated prices within the MUSA.[36] Under economic theory, if the supply of a product is reduced, its price increases. As evidence of price inflation caused by the MUSA policy, the Builders Association asserts that (1) land prices inside the MUSA are increasing, (2) land prices inside the MUSA are significantly higher than prices outside the MUSA, and (3) people are moving to communities just

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33 Dahlgren, Shardlow, and Uban, Inc. *Builders Association of the Twin Cities Study 2000* (Roseville, MN: Builders Association of the Twin Cities, November 2000), 3; and supporting documents about the study.

34 Michael Munson (Metropolitan Council), memorandum to John Patterson (Office of the Legislative Auditor), January 9, 2001.

35 Metropolitan Council, *MUSA Expansion and Land Values* (St. Paul, December 1995); The Builders Association of the Twin Cities, *The High Cost of Sprawl: A Twin Cities Metropolitan Area Urban Services Land Supply Analysis and Recommendation for Managing Growth* (St. Paul, April 1996); and Builders Association of the Twin Cities, "Executive Summary: Builders Association of the Twin Cities Public Policy Committee Presentation to the Metropolitan Council Livable Communities Committee" (February 22, 2000). The Metropolitan Council analyzed the issue again during the summer of 2000 but has not released a report.

36 Dahlgren, Shardlow, and Uban, Inc. *Builders Association of the Twin Cities Study 2000*, cover letter.

outside the seven-county region to avoid the high cost of land.[37] Consequently, the Builders Association wants the Metropolitan Council to immediately make available a 20-year supply of developable land to ensure that prices are not inflated.[38]

No one has systematically analyzed the impact that the Metropolitan Council's land use policy has on land prices.

The Metropolitan Council contends that urban services and other amenities associated with an urban environment account for most of the difference in land prices inside and outside the MUSA.[39] Regardless of how much land is available for development, land that has access to wastewater treatment and is near transportation systems, jobs, shopping, entertainment, parks, and schools is more expensive. In any event, there is currently no published analysis that systematically examines the price of land inside and outside the MUSA and controls for all of the other factors that affect the price of land.

In developing its MUSA policy, the Metropolitan Council is trying to balance competing policy objectives. On the one hand, it wants to facilitate compact and orderly development, but on the other hand, it wants to avoid price inflation. This task is a complex endeavor that requires complete and accurate data and sophisticated analyses. We believe the Council should continue to work with municipalities and other parties, including the Builders Association, to refine its data and analyses.

DEVELOPMENT AND CONSTRUCTION FEES

Municipal governments provide a variety of services related to the growth and development of their communities, including enforcing the building code, administering zoning and subdivision ordinances, providing infrastructure, and offering recreational opportunities. In addition to collecting taxes from residents to pay for these services, communities often assess a variety of fees on development.

As shown earlier in Tables 2.1 and 2.2, we found that:

- **Many builders and developers that we surveyed indicated that development or construction fees significantly limit the production of affordable single-family and multifamily housing.**

Many of the builders and developers mentioned specific fees, including permit and plan review fees, park dedication fees, and sewer and water access charges. For example, one respondent wrote, "[The] cost of water, sewer, plan review, &

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37 Bugbee, Anton & Associates, "Twin Cities Housing and the Impact of the MUSA Line" in *The High Cost of Sprawl: The Twin Cities Metropolitan Area Urban Land Supply Analysis and Recommendations for Managing Growth* (St. Paul: Builders Association of the Twin Cities, April 1996), 4 - 8 in Appendix A.

38 Dahlgren, Shardlow, and Uban, Inc. *Builders Association of the Twin Cities Study 2000*, cover letter.

39 Metropolitan Council, *MUSA Expansion and Land Values* (St. Paul, December 1995), 1; and telephone interview with the report's coordinator, September 7, 2000.

building permits represent up to 10 percent of [the] cost to build a modest 1,500 sq. ft. house." Another commented, "Always a fee for something! If you build 100 townhomes exactly the same, they still charge you $800…for a plan review on each permit even though they have already reviewed it."

Fees charged by the state are minimal.

In this section, we largely focus on the fees that municipalities charge for two reasons. First, state fees are limited to relatively small surcharges on building, electrical, plumbing, and mechanical permits.[40] Second, although the Metropolitan Council's service availability charge (SAC) is currently $1,100 per single family dwelling and $880 per apartment or condominium, the Council annually adopts the SAC fee at public meetings, and according to staff, the Council does not typically receive any comment on its fees. Additionally, unlike any municipal fees of which we are aware, the Metropolitan Council lowers the SAC for public housing that does not have garbage disposals, dishwashers, or individual laundry facilities. Furthermore, the Council is currently experimenting with a SAC waiver program for new units meeting affordable housing criteria.

We briefly examined the costs associated with government fees and found that:

- **Although development and construction fees can vary significantly among cities, it is not clear whether these fees are unreasonably high.**

Under state law, municipalities have broad discretion to establish their own fees.[41] For example, municipalities can follow the schedule for building permit fees provided in the *Uniform Building Code*, but are not required to do so.[42] Consequently, municipalities have adopted widely varying fee schedules. According to the Association of Metropolitan Municipalities' annual *Municipal License and Permit Fee Survey*, building permit fees in the Twin Cities ranged from $508 to roughly $1,000 in 1999, sewer access charges from $20 to $1,900, water access charges from $0 to over $2,150, and park dedication fees from 0 to 10 percent of a property's land value.[43]

Fees charged by municipalities are substantial.

A recent study by the Builders Association of the Twin Cities also reveals substantial variation in the fees charged by different cities. The Builders Association compared the fees in four cities for an identical 1,152 square foot house. As shown in Table 2.4, overall fees varied from $5,036 to $9,259. Building permit fees ranged from $844 to $1,134, city sewer access charges from $25 to $825, city water access charges from $0 to $2,392, and park dedication

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40 State surcharges on building permits are based on a home's value, equaling approximately $50 for a $100,000 home. Surcharges on electrical, plumbing, and mechanical permits are $.50 per permit.

41 City authority to collect fees follows from the general welfare powers provided in *Minn. Stat*. (2000) §412.221, subd. 32. Also, see Country Joe v. City of Eagan (Minn. 1997); http://www.state.mn.us/courts/library/archive/supct/ 9703/c8952289.htm; accessed November 22, 2000).

42 Minnesota adopts the *Uniform Building Code*, subject to various modifications. Modifications to the *Uniform Building Code* include capping the building plan review fees at 65 percent of the building permit fees. Permit fees, however, are not capped (see *Minn. Rules*, chapter 1305, section 107).

43 Association of Metropolitan Municipalities (AMM), *Municipal License and Permit Fee Survey* (St. Paul: AMM, 1999), 26, 45, 59, and 152. The permit fees reported in the AMM survey are for a single family home valued at $100,000.

Municipalities charge a variety of fees.

Table 2.4: Development and Construction Fees in Selected Cities

	Fees per Home or Lot			
	City A	City B	City C	City D
Building and Related Permit Fees				
Park dedication	$1,117	$1,325	$1,200	$1,000
City water access charge	N/A	2,392	500	565
Metropolitan service availability charge	1,050	1,050	1,050	1,050
Building permit	924	987	1,134	844
Plan review	508	543	737	548
City sewer access charge	25	825	410	510
Water meter	50	N/A	N/A	110
Building electrical inspection	85	85	15	85
Plumbing	30	85	36	95
Heat/air permit	30	85	40	80
Water connection	50	85	31	60
State surcharge - building permit	45	50	63	47
Storm sewer connection	50	N/A	N/A	N/A
Electrical permit	N/A	1	75	60
Certificate of occupancy	N/A	25	63	N/A
Windows	N/A	25	N/A	N/A
Gas piping permit	30	N/A	20	N/A
Total Building Permit-Related Fees	3,994	7,562	5,372	5,053
Plat Fees				
GIS fee	N/A	34	N/A	N/A
Base map preparation and recording	N/A	25	N/A	N/A
Preliminary plat	1	6	8	7
Final plat	1	6	1	6
Site plan review	N/A	N/A	N/A	2
Title review	N/A	N/A	1	N/A
Partial release of developer’s agreement	N/A	N/A	0	N/A
Assessment search	N/A	N/A	0	N/A
Total Plat Fees	2	71	9	14
City Engineering Fees				
Storm water trunk, storage, and treatment	N/A	N/A	655	1,148
Storm sewer trunk area charge	29	1,360	655	N/A
Watermain trunk area charge	586	N/A	N/A	472
Sanitary sewer trunk area charge	53	N/A	291	412
Engineering administration	289	213	241	213
Legal and assessing	83	35	N/A	N/A
Grading, erosion, or filling	N/A	0	74	4
Sketch plan review - preliminary	N/A	16	N/A	N/A
Sketch plan review - final	N/A	3	N/A	N/A
Grading plan review fee	N/A	N/A	N/A	1
Total Engineering Fees	1,039	1,627	1,915	2,250
Total Fees	**$5,036**	**$9,259**	**$7,297**	**$7,317**

NOTE: The table is based on cost information from four cities in the Twin Cities metropolitan area. The fee data is based on a 1,152 square foot home and plat #2 from the Builders Association study. The Builders Association kept the cities anonymous to ensure their cooperation. N/A means not applicable.

SOURCE: Builders Association of the Twin Cities, *Fees, Infrastructure Costs, and Density… their impact upon the Twin Cities regional growth strategy and life-cycle housing goals* (Roseville, MN: Builders Association of the Twin Cities, 2000), appendix tables.

fees from $1,000 to $1,325.[44] The $4,223 difference in overall fees between the highest and lowest-charging cities adds costs to a home.[45]

Without more extensive research, we can not conclusively determine whether the fees in some communities are unreasonably high. Communities can finance growth and development in a number of ways. For example, one community may charge high initial water access fees and lower quarterly water bills, while another may charge low initial fees with higher on-going bills. However,

- **According to the Minnesota Attorney General's Office, fees are not intended to be a source of general revenue but should cover the costs of associated services.**

In 1991, Minnesota's Department of Administration requested that the Attorney General offer an opinion on the department's position that, "revenue received by municipalities for building permits and plan review services should approximate the cost incurred by the municipality to administer the building code."[46] The Attorney General's Office responded in the affirmative and based its decision upon case law relating to license fees rather than building permits, which suggests that *all* fees and surcharges—not just the building permit fees mentioned in the Department of Administration's original inquiry—must bear a reasonable connection to the costs of regulation.[47]

Evidence suggests that some municipal fees are excessive.

Evidence suggests that some municipalities use fees to generate revenues beyond what is necessary to administer codes, enforce ordinances, and provide services. An advisory group to the Minnesota Construction Codes Advisory Council (CCAC) recently found that only 11 of 34 cities surveyed spent approximately the same amount on building code enforcement that they brought in through building permit fees.[48] Seven of the 34 cities reported permit fee revenues twice the size of their building code expenditures. While this evidence should be considered

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44 Because some fees are based on a home's value (particularly permit fees), part of the variation is explained by variations in assessed value. Although the home was identical in all cases, the city valuations varied from $90,968 to $125,100. Builders Association of the Twin Cities, *Fees, Infrastructure, Costs, and Density*, appendix tables.

45 BATC did not name the cities used in their analysis in order to maintain cooperation with the cities and focus it report on the effects of municipal ordinances on costs, rather than the policies of particular cities. An earlier study by Barbara Lukermann and Michael Kane provides similar evidence regarding variation in fees among ten suburbs in the Twin Cities area. According to Lukermann and Kane, selected fees per unit on a hypothetical 40-acre single-family development were highest in Lakeville ($5,035) and lowest in Edina ($1,225); *Land Use Practices: Exclusionary Zoning, de Facto or de Jure?* (Minneapolis: University of Minnesota Center for Urban and Regional Affairs, 1994), 24.

46 Charlene W. Hatcher, Special Assistant, Office of the Attorney General, to B. Michael Godfrey, Building Code Representative, Department of Administration, *Municipal Building Permit Fees and Municipal Building Code Administration Costs*, February 6, 1991, memorandum.

47 The case law cited in the Attorney General's Office opinion states, "Unless, however the amount is manifestly unreasonable in view of its purpose as a regulation, the court will not adjudge it a tax" and, therefore, illegal. State of Minnesota v. Northern Raceway Corporation, 381 N.W.2d 526, 529 (Minn. 1986). Also see Country Joe v. City of Eagan (Minn. 1997).

48 Fee Technical Advisory Group, *The Use of Building Construction Fees by Minnesota's Governments* (St. Paul: Construction Codes Advisory Council, August 1999). The CCAC consists of representatives of state agencies, private industry, and local government, and is staffed by the Department of Administration (*Minn. Stat*. (2000) §16B.76).

incomplete, it raises the possibility that some cities may be charging fees that inappropriately add to the cost of new housing.

Because of its study, the CCAC recommended that the state require municipalities to segregate permit fee revenues in a fund specially dedicated for administering and enforcing the state building code.[49] Dedicated funds of this type are not uncommon. For example, the Department of Administration must place the fees it collects for building code enforcement in an account designated for those purposes,[50] and municipalities must place park fees in a dedicated fund.[51] Extending this mandate to building permit and other fees collected by local governments would help ensure that fees are commensurate with the services for which they are intended.

It is important to realize that development and construction fees serve a valid function—financing municipal operations. While it may be appropriate to ensure that municipalities limit their fees to the cost of providing associated services, any reduction in fees will mean a loss of revenue for municipalities that will have to be made up elsewhere in their budgets.[52]

STATE BUILDING AND FIRE CODES

The state building code is a compilation of minimum uniform standards and requirements for constructing new buildings and remodeling existing ones. These standards govern design, construction, materials, fire protection, energy conservation, health, safety, and sanitation.[53] Minnesota's code was originally adopted to help lower construction costs and is meant to permit building construction at the least possible cost consistent with recognized health and safety standards.[54]

The state building code is meant to allow construction at the least possible cost consistent with recognized health and safety standards.

State statutes require that the building code conform as much as possible to model codes that are generally accepted and used nationally. In addition, the Department of Administration uses the Administrative Procedure Act to amend the building code every three years. This allows Minnesota to keep its code as current as possible. Finally, although the state building code is not mandatory throughout Minnesota, most of the state's residents are covered by the code. Statutes require that all counties in the seven-county metropolitan area adopt the state building

49 Fee Technical Advisory Group, *The Use of Building Construction Fees by Minnesota's Governments*. Appendix E of the report contains proposed legislation.

50 *Minn. Stat.* (2000) §16B.70, subd. 2.

51 *Minn. Stat.* (2000) §462.358, subd. 2b.

52 Following a recommendation from the Mayors' Regional Housing Task Force (*Affordable Housing for the Region: Strategies for Building Strong Communities*, 20), the Metropolitan Council, the Association of Metropolitan Municipalities, and the Builders Association of the Twin Cities currently plan to collaborate on a study of fees in late 2001.

53 State fire code provisions regarding constructing and remodeling housing overlap with identical provisions in the state building code.

54 *Minn. Stat*. (2000) §16B.59.

The state building code dictates how housing is constructed or remodeled.

code.[55] Ten other counties in southeastern Minnesota and about 170 cities and townships throughout the rest of the state have voluntarily adopted the state building code. Although only 20 percent of the state's counties, 44 percent of its cities, and 12 percent of its townships are covered by the building code, about 80 percent of the state's population live in these jurisdictions. In addition, local jurisdictions that are not required to adopt the building code may not adopt another code in its place, nor can adopting jurisdictions amend building code provisions. Thus, builders can use stock housing plans because they do not have to accommodate different building standards across communities.[56]

As shown earlier in Tables 2.1 and 2.2,

- **Many builders that we surveyed said that the building code significantly limits the production of affordable housing in Minnesota, especially single-family homes.**

The state's new energy code is of particular concern to builders.

When asked to be more specific, nearly two-thirds of builders who responded identified the building code's new energy provisions for single-family housing as an example. In fact, one builder commented, "[The] new energy code is regressive when you view it as a percentage of total price, meaning it is felt hardest by the lowest priced housing market."

Unlike most of the building code's other provisions, those related to energy conservation are not based on a national model code. The 1991 Legislature

55 *Minn. Stat.* (2000) §16B.62. Because the state fire code is mandatory throughout the state, the building code's fire protection provisions are mandatory statewide.

56 As we discussed earlier, cities are still free to adopt zoning ordinances that place additional restrictions on homes or the construction process.

required that the building code's energy provisions be equal to or exceed the most stringent requirements adopted by any other state.[57] Presently, builders can choose between two sets of energy standards when constructing one- and two-family housing; a third set of standards governs multifamily housing. The newest provisions for one- and two-family housing became effective in April 2000. These regulations are designed to address indoor air quality problems in detached one- and two-family homes by requiring additional ventilation and measures to prevent backdrafting of gas appliances that were previously optional.

The Minnesota Department of Commerce estimates that the new energy provisions that became effective in April 2000 add about $3,000 to $5,000 to the cost of a new home. Some local builders estimate increased costs of $3,000 to $8,000, while others say it costs more. Responding to concerns about increased cost, the 2000 Legislature required the Department of Administration to examine the cost-effectiveness of the building code's energy provisions and the feasibility of establishing new criteria for various types of housing. The report is due December 2001.[58]

Although builders did not discuss whether the building code limits their ability to rehabilitate existing buildings, we noted that:

- **The state building code lacks provisions specific to the rehabilitation of existing buildings, which may lead to increased costs.**

The Legislature has required the state to adopt specific code provisions for the rehabilitation of existing buildings.

Major remodeling or changes in an existing building's occupancy or use require builders to comply with code provisions for new structures. This might deter builders from rehabilitating or converting abandoned, condemned, or existing buildings to housing units. In 1999, the Legislature required the state to adopt building code provisions for existing buildings, also referred to as building conservation.[59] The Department of Administration is currently examining some model codes for existing buildings. These codes typically give building officials more guidance and flexibility to make trade-offs that do not require existing buildings to meet all of the requirements of new buildings. The department plans to include building conservation provisions in the code when it adopts the updated version of the *Uniform Building Code* in 2002.

Finally, a number of builders also said that inconsistent enforcement has made it difficult to build affordable housing. We found that:

- **How the state building code is administered and enforced locally can increase housing costs by reducing uniformity for builders.**

Some building code provisions are optional. For example, municipalities can choose to adopt Chapter 1306, which sets forth more stringent fire protection requirements. This optional chapter requires that sprinkler systems be installed in apartment buildings with 8,500 or more gross square feet of floor area or with dwelling units on three or more floors. In contrast, the state building code simply

57 *Minn. Laws* (1991), ch. 149, sec. 4. The 1999 Legislature repealed this requirement; the current energy provisions were developed before the repeal. See *Minn. Laws* (1999), ch. 135, sec. 10.

58 *Minn. Laws* (2000), ch. 407.

59 *Minn. Laws* (1999), ch. 135, sec. 1.

requires sprinklers when buildings are at least three stories high or have at least 16 units. According to the Department of Administration, at least 19 cities, mostly in the seven-county metropolitan area, have adopted the more stringent fire protection requirements in Chapter 1306. In our survey, some builders indicated that the state building code significantly limits the production of affordable housing in part because additional fire protection requirements in some cities make it more expensive to build there.

Local building officials have considerable discretion in enforcing and interpreting the code.

Also, local building officials have considerable discretion in enforcing and interpreting building code provisions, and this can lead to variation across and within municipalities. For example, the code encourages builders to seek new ways to meet the code's goals, and building officials are given wide latitude to grant "equivalencies."[60] Building officials also have considerable discretion in how they interpret unclear or ambiguous portions of the code. Therefore, builders may not receive the same equivalencies or interpretations from building officials in different jurisdictions and consequently builders may not be able to build homes for the same cost in different communities.

In addition, local fire officials might not approve or be aware of equivalencies or interpretations that local building officials have made regarding building code provisions that overlap with the state fire code. In these instances, fire officials might determine that buildings do not comply with the fire code—a necessary condition for a certificate of occupancy. Builders may have to make last minute changes to satisfy fire officials. One builder told us that builders are reluctant to appeal such actions because of the time and money involved.

At the request of the Legislature, the Department of Administration is addressing issues related to the building code, such as energy code requirements and building conservation. Possible solutions to builders' concerns about inconsistent enforcement have been discussed in a previous report from our office on the state building code.[61] That report presented a variety of options to address inconsistent enforcement. Also, the Department of Administration plans to include an updated appeals process in the building code when it adopts the new version of the *Uniform Building Code* in 2002. The department is also proposing legislation to upgrade the criteria for disciplining building officials who are not administering the code uniformly.

FINANCING

As discussed in Chapter 1, new housing is often unaffordable without subsidies. As shown earlier in Tables 2.1 and 2.2, we found that:

- **A majority of local housing organizations cited financing issues as a factor that significantly limits the production of affordable housing.**

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60 An equivalency is a measure other than a code requirement that provides essentially the same protection as a code requirement.

61 Office of the Legislative Auditor, *State Building Code* (St. Paul, January 1999).

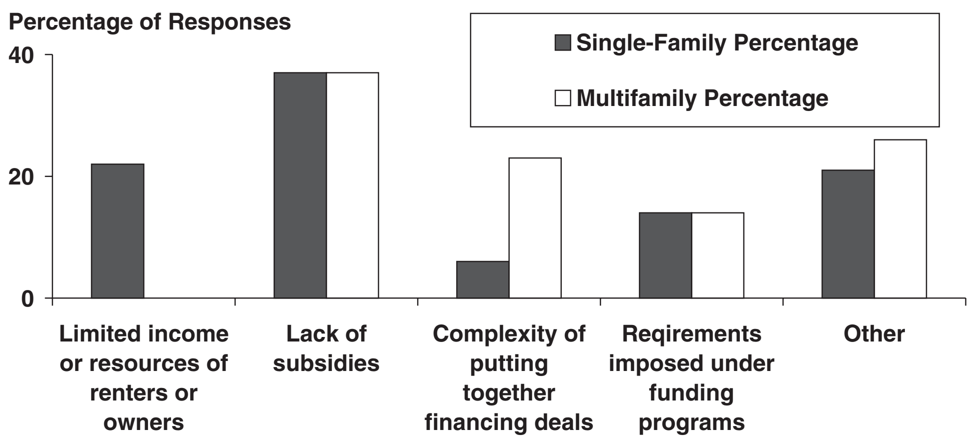
Local housing organizations believe there are not enough subsidies and that housing finance packages are too complex.

A lack of subsidies and the complexity of putting together a financing package were the most often cited examples of this impediment. For example, one local housing organization wrote in its survey, "Never enough money," while another commented, "Financing of affordable housing is unbelievably complex and time consuming." Figure 2.2 shows the most frequently mentioned examples of financing issues that local housing organizations cited.

In the last two years, applicants for multifamily housing assistance requested 3.8 times as much money as the Minnesota Housing Finance Agency (MFHA) could provide, a sign that there is a demand for more assistance.[62] In addition, as discussed in Chapter 1, approximately 18 percent of all Minnesota households were lower income and spend more than 30 percent of their income on housing in 1989. Some housing advocates are calling for the state to devote 1 percent of the general fund to housing programs.[63] Currently, the state devotes about one-half of 1 percent to these programs.[64]

The following example illustrates why many people believe that more financial assistance is needed to make new housing affordable. Most owners of single-family homes pay mortgages. As Table 2.5 shows, at 2000 interest rates (around 8 percent), a family living in a non-metropolitan area with an income at 80 percent of the median could afford a $95,000 house. But, the family could not

Figure 2.2: Percentage of Local Housing Organizations that Cited Various Financing Issues as Impediments



NOTE: We asked local housing organizations who identified financing as a marginal or significant barrier to provide an example. This graph shows the percentage of respondents who reported each of the identified examples. Due to our sampling method, we are unable to provide a precise margin of error for each response rate. See Appendix A. *N* = 65 for single-family organizations and 43 for multifamily organizations.

SOURCE: Office of the Legislative Auditor's survey of local housing organizations, July and August 2000.

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62 Minnesota Housing Finance Agency, unpublished table titled "Multifamily RFP: Requests vs. funded last 4 rounds," received November 27, 2000.

63 Family Housing Fund, "Policy Initiatives," http://www.fhfund.org/Policy/1percent.htm; accessed March 13, 2000.

64 Minnesota Department of Finance, *Fund Balance Analysis: General Fund, End of 2000 Legislative Session* (St. Paul: May 31, 2000), 1 and 7.

Table 2.5: Maximum Home Values that Households with 80 Percent of Median Family Income Could Afford in 2000

Mortgage Interest Rates	Non-Metropolitan Areas ($35,440 Income)	Metropolitan Areas ($52,480 Income)
6.50%	$106,000	$157,000
7.00	102,000	151,000
7.50	98,000	146,000
8.00	95,000	140,000
8.50	91,000	136,000
9.00	88,000	131,000
9.50	85,000	126,000
10.00	82,000	122,000
10.50	80,000	118,000

NOTE: The affordable home values are based on a 30-year, fixed-rate mortgage at the specified interest rate and a 10 percent down payment. The calculations also assume that house payments cannot exceed 28 percent of a household's income.

SOURCE: Office of the Legislative Auditor's analysis using a mortgage payment model provided by the Minnesota Housing Finance Agency.

afford the new $116,000 starter home discussed in Chapter 1 even with a low-interest MHFA loan.[65] In 2000, MHFA offered 6.5 percent mortgages (about 1.5 percentage points below market rates), which would allow the family to buy a $106,000 home. The $116,000 home would only be affordable if the housing project received additional subsidies, such as deferred loans and grants. This affordability gap occurs even when the nation has historically low interest rates. As shown in Figure 2.3, interest rates have been as high as 16 percent in the last 20 years. While this $116,000 starter home would be affordable in metropolitan areas, developers and builders told us that it would be difficult to built a home at this price in some areas because of the high price of land.

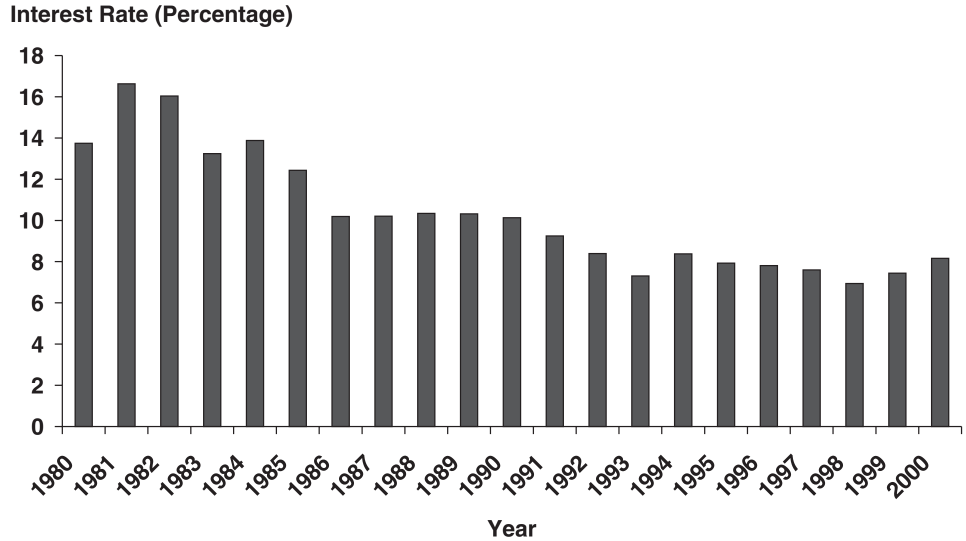
During interviews, we asked local housing officials about the complexity of housing financing packages. They told us that a typical project receives funding from six or more sources, which may have different applications, funding cycles, and program requirements. In addition, many funding sources want their funds to leverage other funds and consequently require projects to receive funding from multiple sources. Therefore, losing one source of funds can jeopardize an entire project, which makes investing time and money into affordable housing risky.

The Minnesota Housing Finance Agency has tried to simplify its funding process.

MHFA has tried to address these issues by establishing a simplified funding process—commonly referred to as a "super request for proposals (RFP)." The agency combines funding from some of its programs into a single pool with one application along with funding from the Metropolitan Council, Family Housing Fund, and Greater Minnesota Housing Fund. (The last two organizations are non-profit housing finance agencies). Minneapolis and St. Paul have also tried to

65 The Minnesota Housing Finance Agency's mortgage programs have cost limits for new homes. For 2000, this $116,000 home would exceed the limit for the Minnesota Mortgage Program but fall below the $131,070 limit for the Community Activity Set-Aside Program.

Figure 2.3: Average Annual Interest Rates for 30-Year Fixed-Rate Mortgages



SOURCE: Federal Home Mortgage Corporation, table titled "Primary Mortgage Market Survey: 30-Year Fixed-Rate Mortgages Since 1971," http://www.freddiemac.com/pmms.abtpmms.htm; accessed December 4, 2000. The rate for 2000 is the average for the first 10 months of the year.

link their application processes and priorities into the super RFP. Yet, in interviews, local housing officials told us that while the super RFP has helped, it has not solved the problem because it is still just one piece of the funding puzzle.

MHFA has also tried to increase the flexibility of its funding selection process. For example, the agency allocated 2001 tax credits (which help subsidize affordable housing) in the fall of 2000 so that they would be ready for the 2001 construction season. The agency also eliminated preferences previously given developments with certain architectural amenities, such as units with both an eat-in kitchen and dining room.[66]

Subsidies for affordable housing projects can come from several sources – federal, state, or local governments or nonprofit or philanthropic organizations. In the following three sections, we provide a brief discussion of each of these sources.

The focus of federal housing policy has shifted several times over the last 60 years.

Federal Financing

The federal government's role in subsidizing housing started during the Great Depression when it took steps to stabilize the nation's housing stock, encourage home construction, and promote home ownership. To help create construction

66 Minnesota Housing Finance Agency (MHFA), "Report, Multifamily Development Cost Review," unpublished memorandum to MHFA board, September 24, 1998; MHFA, "Review of Roundtable Discussion," unpublished summary of a roundtable discussion of MHFA's customers, August 20, 1998; and interviews with MHFA staff.

jobs, Congress also passed the Housing Act of 1937, which allowed states to establish local public housing authorities to build, own, and manage housing. Since then, the focus of federal policy first shifted from constructing public housing to subsidizing the construction of low-income private housing and finally to providing rent subsidies that recipients can take with them when they move. Table 2.6 describes the federal government's major programs.

When we examined federal spending on housing programs, we found that:

- **Despite a large reduction in federal *appropriations* in the late 1970s and early 1980s, federal *spending* on housing has remained relatively constant after adjusting for inflation.**

Figure 2.4 shows federal appropriations and spending for housing programs since 1976. According to the United States Office of Management and Budget, the large differential between housing appropriations and spending in the late 1970s and early 1980s is due to the way the federal government funded the Section 8 New Construction/Substantial Rehabilitation program.[67] At that time, Congress appropriated all the funding needed for 20- or 40-year contracts up front, and the U.S. Department of Housing and Urban Development (HUD) then spent the appropriation over the term of the contract. Consequently, Congress appropriated money that was not needed for another 10, 20, or even 40 years. When Congress revoked HUD's authority to enter into additional contracts in 1983, the differential largely disappeared. Housing advocates content that if the federal government had maintained its housing appropriations at the level from the late 1970s, federal housing spending would have eventually risen to over $100 billion annually. Nevertheless, the federal government kept spending relatively constant during this period (around $30 billion annually). Housing advocates also claim that more money is needed because housing needs have increased over the last 25 years.

We also found that:

The federal Tax Reform Act of 1986 had a significant effect on multifamily housing production.

- **With respect to tax policy, the federal government's involvement in affordable housing has declined significantly.**

The federal Tax Reform Act of 1986 reduced or eliminated many tax incentives to build multifamily rental housing, some of which were only enacted five years earlier with the 1981 Economic Recovery Tax Act. Among other things, the 1986 act (1) eliminated accelerated depreciation, (2) ended the deductibility of construction-period interest and taxes in the year they were incurred, and (3) restricted the deductibility of passive losses.[68] As Figure 1.9 in Chapter 1 showed, the production of multifamily housing in Minnesota dropped off around 1986.[69]

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67 Steve Redburn (Chief of the Housing Branch, United State Office of Management and Budget), telephone interview by author, August 1, 2000.

68 Janet Larsen and Joane Vail, *The Effects of the 1986 Tax-Reform Act on Affordable Multifamily Housing in the Twin Cities Area* (St. Paul: Metropolitan Council, April 1989), 7; and Advisory Commission on Regulatory Barriers to Affordable Housing, *"Not in My Back Yard," Removing Barriers to Affordable Housing* (Washington, DC: United States Department of Housing and Urban Development, 1991) 5-4 and 5-5.

69 National production of multifamily housing experienced a similar decline.

Table 2.6: Major Federal Housing Programs

- **Public housing** is owned, operated, and managed by Public Housing Authorities. While the federal government no longer subsidizes the construction of new public housing, it still subsidizes the operation and modernization of existing buildings, with most tenants paying 30 percent of their income on rent. In 1999, Minnesota received $70 million in operating and modernization funding.

- **Section 8 new construction/substantial rehabilitation** (often referred to as project-based assistance) provides long-term subsidy contracts (up to 20 or 40 years) for parties that build affordable rental housing. While Congress revoked HUD's authority to enter additional contracts in 1983, the federal government still provides subsidies under existing and renewed contracts. Tenants usually pay 30 percent of their income for rent. In 1999, Minnesota received about $130 million in subsidies.

- **Section 8 certificates and vouchers** are rent subsidies that recipients can take with them when they move, rather than being tied to specific housing. Tenants pay about 30 percent of their income on rent. In 1999, Minnesota received $88 million in rent subsidies.

- **HOME** (the Home Investment Partnership Program) is a grant program for states and local governments to acquire, rehabilitate, or construct affordable housing for low-income renters or owners. In 1999, Minnesota received $20 million in grants.

- **Community Development Block Grants (CDBG)** fund community development efforts, including housing. Local governments that receive funding have wide discretion in its use. In 1999, Minnesota received $70 million in grants.

- **The Federal Housing Administration (FHA) and Department of Veterans Affairs (VA)** insure and guarantee loans, which increase housing market access for some families. Based on loan values, these two programs insured or guaranteed 12 percent of the nation's mortgages for family homes and 7 percent of the mortgages for multifamily properties in 1997.

- **Rural Housing Service** in the United States Department of Agriculture provides rent subsidies, direct loans, and loan guarantees in rural areas. In 1999, they provided $29 million in interest and rental subsidies in Minnesota.

- **Low-Income Housing Tax Credits** are federal income tax credits for people or companies that invest in the construction or substantial rehabilitation of rental housing. Developers of rental housing sell the credits to investors. Proceeds from credit sales can cover nearly two-thirds of a project's development and construction costs.

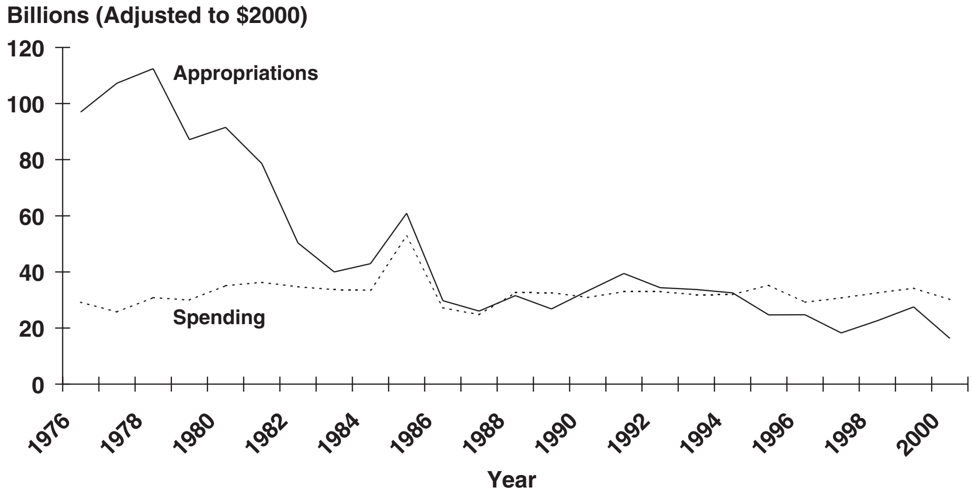
- **Tax exempt bonds** are sold by state and local governments. Buyers accept a lower interest payment because it is not taxable income. State and local housing agencies use the bond proceeds to finance mortgages with below-market interest rates.

- **Income tax deductions for mortgage interest and property taxes** are additional subsidies for homeownership.

- **Federal Home Loan Banks** provide credit to more than 7,600 member financial institutions. Federal law requires the 12 District Home Loan Banks to establish affordable housing and community investment programs, under which the district banks provide low-cost funds for affordable housing and community investment programs.

SOURCES: All funding information came from the Minneapolis Office of the United States Department of Housing and Urban Development (HUD), except for: (1) data on FHA and VA loan volumes, which came from HUD, "Survey of Mortgage Lending Activity Report: Annual 1997," http://www.hud.gov/fha/comp/rpts/smla/gf97ann4.html, accessed on August 11, 2000; and (2) data on the Rural Housing Service which came from the St. Paul Office of the Rural Housing Service.

Figure 2.4: Federal Funding for Housing Programs, 1976-2000



NOTE: Funding figures come from three federal budget categories, housing assistance, community development, and mortgage credit. Not all community development funding is for housing programs.

SOURCE: United States Office of Management and Budget, *Historical Tables: Budget of the United States Government, Fiscal Year 2001* (Washington DC: U.S. Government Printing Office, 2000), 50-90.

The federal government recently increased Minnesota's allocation of tax credits and tax-exempt bonds.

The Tax Reform Act of 1986 also created low-income housing tax credits but capped their use along with the use of tax-exempt bonds. The act capped each state's allocation of low-income housing tax credits at $1.25 per capita and certain tax-exempt bonds at $50 per capita. Both allocations have since declined 25 percent, after adjusting for inflation.[70] However, in December of 2000, Congress increased the caps for both programs for the first time. For example, in 2001, the federal government will cap tax credits at $1.50 per capita and tax-exempt bonds at $62.50 per capita.[71]

Tax-exempt bonds and tax credits are important sources of financing for affordable housing in Minnesota. The state received a tax-exempt bond allocation of $239 million in 2000 from the federal government, only a portion of which was used for housing. In 1999, the state used 43 percent of its bond allocation for single-family housing and 17 percent for rental housing.[72] In addition, the state received $6 million in tax credits under the federal cap in 2000.[73] The value of low-income housing tax credits is greater than the allocation because investors use them for ten years. For example, if a housing project sells $100,000 of credits, investors receive $100,000 in tax breaks for each of the next ten years, for a total

70 Office of the Legislative Auditor's analysis of data from the Minnesota Department of Finance and Minnesota Housing Finance Agency.

71 Katherine G. Hadley (Minnesota Housing Finance Agency), "Affordable Housing Increases in the Omnibus Spending Bill," memorandum to Leonard Inskip, December 20, 2000.

72 Office of the Legislative Auditor's analysis of data from the Minnesota Department of Finance, tables titled "Minnesota Tax Exempt Bond Allocations – 1999: State Cap & Pool Status" (January 1, 1999) and "Minnesota Tax Exempt Bond Allocations – 2000: State Cap & Pool Status" (August 7, 2000).

73 Minnesota Housing Finance Agency staff.

of $1 million dollars in savings. However, investors will only pay about $700,000 for the credits because the tax breaks will be used over ten years.[74] A $100,000 tax break ten years from now is not worth $100,000 today.

State Financing

The state administers an assortment of housing programs through the Minnesota Housing Finance Agency.

The most visible role that the state of Minnesota plays in providing housing to low- and moderate-income households is through the Minnesota Housing Finance Agency. The agency's principal activity is to finance loans that have below-market interest rates with tax-exempt bonds. The agency also provides rental assistance payments, primarily through the federal government's Section 8 program, and other forms of assistance, including deferred loans, grants, and tax credits.

During the 1998-99 biennium, MHFA's largest source of funding was bond proceeds, accounting for 57 percent of its budget. The federal government contributed another 16 percent, the state provided 10 percent, and agency reserves accounted for the remaining 17 percent.[75] Through these revenue sources, MHFA provided $292 million of assistance to 29,000 households in 1999. As Figure 2.5 shows, home mortgage programs accounted for nearly half of all assistance, while rental and home improvement programs accounted for 38 and 14 percent respectively.[76] Tables 2.7 and 2.8 describe the agency's major programs.

As Figure 2.6 shows, MHFA experienced a drop in state appropriations in the early 1980s just like federal agencies. However, unlike federal agencies, MHFA experienced a dramatic increase during the last two bienniums. For the 2000-01 biennium, the agency's appropriation increased from $83 million to $143 million, a 63 percent increase after adjusting for inflation. MHFA accounts for most but not all state appropriations for housing programs. According to the House of Representatives Research Department, $121 million of the $129 million originally appropriated for housing for the 2000-01 biennium went to MHFA. The other $8 million went to various other agencies, primarily to assist people with special needs.[77] During the 2000 session, the Legislature appropriated an additional $23 million for the biennium to MHFA and another $30 million for fiscal year 2002 in the next biennium.[78]

During the 1999 session, the Legislature created two new MHFA programs aimed at overcoming financial and regulatory factors that limit the production of affordable housing—the Innovative and Inclusionary Housing Program and the Economic Development and Housing Challenge Program. Under the Innovative and Inclusionary Housing Program, the Legislature appropriated $8 million to fund housing developments that demonstrate innovative building techniques or

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74 According to MHFA staff, credits usually sell for 70 cents on the dollar.

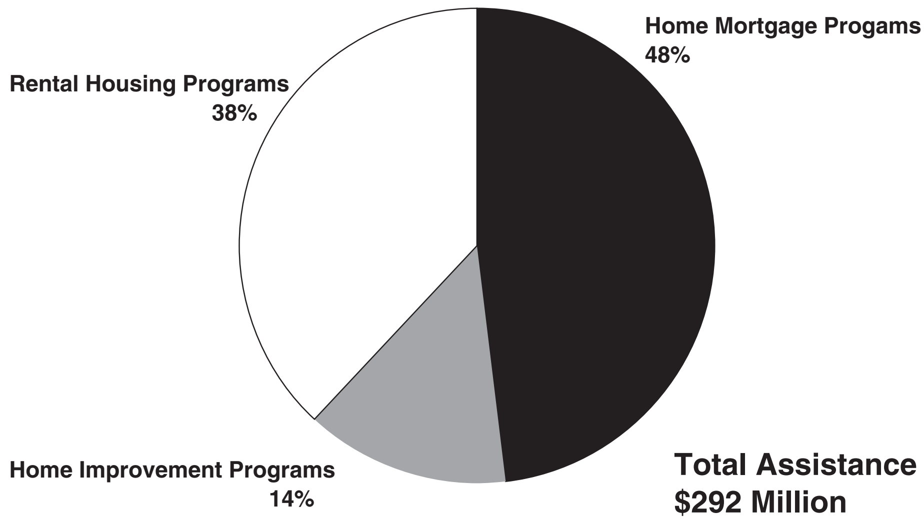
75 Minnesota Department of Finance, *Minnesota Biennial Budget: Economic Development, 2000-01* (St. Paul, 1999), E-143.

76 Minnesota Housing Finance Agency, *2000 Program Assessment: October 1, 1998 – September 30, 1999* (St. Paul, 2000), 12-18.

77 Wendy L. Simons and Deborah McKnight, *Housing Legislation 1999: A Summary* (St. Paul: Minnesota House of Representatives Research Department, September 1999), 3-5.

78 Minnesota Housing Finance Agency, unpublished document titled "REVIEW, 2000 LEGISLATIVE SESSION," May 24, 2000.

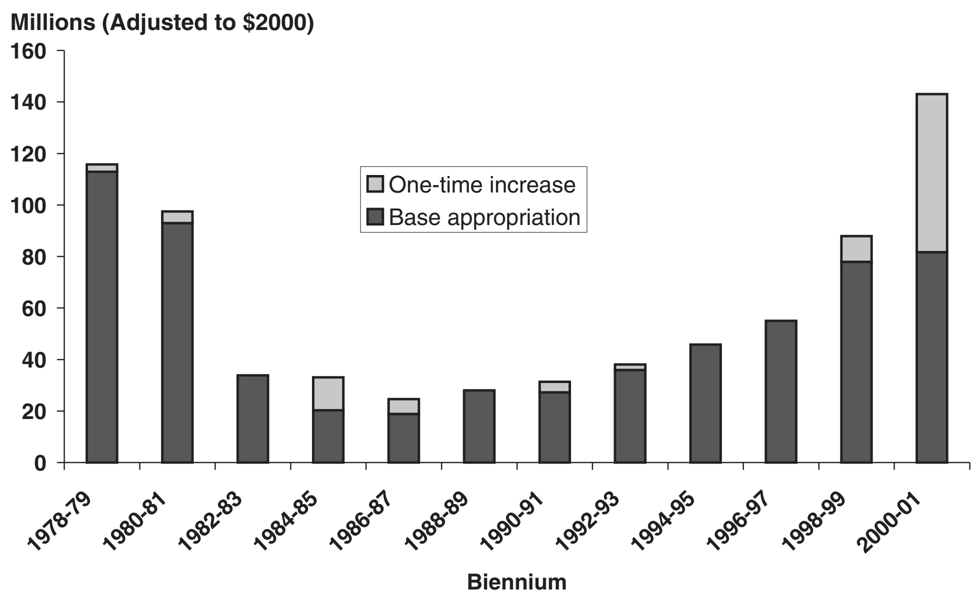
Figure 2.5: MHFA Assistance by Program Type, 1999



SOURCE: Minnesota Housing Finance Agency, *2000 Program Assessment: October 1, 1998 - September 30, 1999* (St. Paul, 2000), 14-18.

The Minnesota Housing Finance Agency's appropriation has increased substantially in recent years.

Figure 2.6: State Appropriations to MHFA,1978-79 to 2000-01



SOURCE: Minnesota Housing Financing Agency, unpublished budget documents.

The principal activity of the Minnesota Housing Finance Agency is to finance loans with below-market interest rates.

Table 2.7: Major State Housing Programs

Home Mortgages

- **Minnesota Mortgage Program** provides mortgages with below-market interest rates to first-time homebuyers through the sale of mortgage revenue bonds.
- **Minnesota City Participation Program** is part of the Minnesota Mortgage Program, in which MHFA sets aside funds from the sale of mortgage revenue bonds for cities to meet locally identified housing needs.
- **Community Activity Set-Aside** is a third part of the Minnesota Mortgage Program, in which MHFA sets aside funds from the sale of mortgage revenue bonds for lenders, local governments, or nonprofit housing providers to meet homeownership needs in their communities.
- **Minnesota Urban and Rural Homesteading** awards grants to organizations and public agencies that acquire, rehabilitate, and sell single-family homes that are vacant, condemned, or blighted to at-risk first-time homebuyers.

Home Improvement and Rehabilitation

- **The Great Minnesota Fix-Up Fund** provides home improvement loans with below-market interest rates for low- and moderate-income homeowners.
- **Community Rehabilitation Fund** provides grants to cities for acquisition, rehabilitation, demolition, and new construction of single-family homes.

Rental Housing

- **Section 8 Project-Based Assistance** subsidizes the rent for low-income households that live in buildings with contracts with the Department of Housing and Urban Development. MHFA administers only about half of the HUD contracts.
- **Low and Moderate Income Rental Program** provides mortgages and rehabilitation funds for the acquisition and rehabilitation or new construction of rental housing for low- and moderate-income families.
- **Affordable Rental Investment Fund (ARIF)** provides low-interest first mortgages or deferred loans to help cover the costs of acquisition and rehabilitation or new construction of low-income rental housing.
- **ARIF Preservation** provides deferred loans with no or little interest to federally-assisted rental housing at risk of being converted to market rate.
- **Low Income Housing Tax Credits (LIHTC)** are MHFA’s share of the tax credits allocated to Minnesota.
- **HOME Rental Rehabilitation** provides grants to rehabilitate privately-owned rental property in order to support affordable, decent, safe, and energy efficient housing for lower-income families.
- **Housing Trust Fund** provides deferred loans without interest for the development, construction, acquisition, preservation, or rehabilitation of low-income rental housing.
- **Rental Rehabilitation Loans** provide property improvement loans to rental property owners.

SOURCE: Program documents from the Minnesota Housing Finance Agency.

Table 2.8: Program Details for MHFA's Major Programs, 1999

Program	Type of Assistance	Amount of Statewide Assistance (in Millions)	Funding Source	Number of Housing Units Assisted	Median Annual Income of Assisted Households
Home Mortgage Programs					
Minnesota Mortgage Program	Low-interest loans	$90	MHFA bond proceeds	1,500	$25,812
Minnesota City Participation Program	Low-interest loans	25	MHFA bond proceeds	378	27,879
Community Activity Set-Aside	Low-interest loans	10	MHFA bond proceeds	129	29,000
Minnesota Urban and Rural Homesteading (MURL)	Grants	4	State appropriations and federal funds	37	N/A
Home Improvements and Rehabilitation Programs					
The Great Minnesota Fix-Up Fund	Low-interest loans	$21	MHFA bond proceeds and fund balances	2,143	$30,524
Community Rehabilitation Fund	Grants	7	State appropriations	141	N/A
Rental Housing					
Section 8 Project-Based Assistance	Rent Subsidies	$63	Federal funds	13,025	N/A
Low and Moderate Income Rental Program [a]	Loans and rehabilitation funding	18	MHFA bond proceeds and fund balances	808	$11,736[b]
Affordable Rental Investment Fund (ARIF)	Low-interest and deferred loans	6	State appropriations and fund balances	504	14,418
ARIF Preservation	Low- or no-interest deferred loans	5	State appropriations and federal funds	60	N/A
Low Income Housing Tax Credits (LIHTC)	Tax credits	4	Federal tax expenditures	662	N/A
HOME Rental Rehabilitation	Grants	3	Federal funds	304	11,016
Housing Trust Fund	No-interest deferred loans	2	State appropriations	481	9,112
Rental Rehabilitation Loans	Low-interest loans	2	Fund balances	478	20,000

NOTE: N/A means not available. Housing units that received funding from more than one MHFA program are identified once, under the program that provided the greatest portion of total assistance.

[a]Combination of the Low and Moderate Income Rental First Mortgage, New Construction Tax Credit Mortgage, and Bridge Loan programs.

[b]Excludes recipients of the New Construction Tax Credit Mortgage and Bridge Loan Programs. Data for these two programs are not available.

SOURCE: Minnesota Housing Finance Agency program documents.

materials and are located in communities willing to waive local restrictions that increase housing costs.[79] In Chapter 3, we provide some examples of these developments. Under the Economic Development and Housing Challenge Program, the Legislature appropriated $20 million for MHFA to provide grants and loans to housing projects with financial contributions from area employers, local governments, and private philanthropic organizations.[80]

79 *Minn. Laws* (1999), ch. 223, art. 2, sec. 54. One half of the money went to MHFA, while the other half went to the Metropolitan Council.

80 *Minn. Laws* (1999), ch 223, art. 2, sec. 56.

Local and Philanthropic Sources of Financing

Local governments and philanthropic organizations also provide housing assistance.

Local governments and philanthropic organizations also provide financing for affordable housing projects. Table 2.9 briefly describes some major sources. Although we did not collect information about how much money each source provides, in our survey, we asked local housing organizations to indicate what sources of funds (federal, state, local, and private), they used in 1999 to develop, construct, or rehabilitate affordable housing. We did not ask about programs that subsidize rent or mortgage payments after the housing is built. Table 2.10 shows the percentage of local housing organizations that used each source. Community Development Block Grants, federal HOME funds, MHFA's Community Revitalization Fund, and tax increment financing appear to be the most widely used funding sources.

Table 2.9: Other Sources of Financing

Local Government Sources

- **Local bonds** that finance affordable housing come in two types. First, revenue bonds typically finance mortgages and are paid off with mortgage repayments. Second, general obligation bonds are paid off with local tax collections.

- **Tax increment financing** districts may be established by local governments. In these districts, local governments (1) "capture" the property tax revenue generated by a new development on top of what would have been collected without the project and (2) use the "captured" revenue to help finance the project.

- **Local tax levies** may be used to directly finance affordable housing.

- **Local housing trust funds** are local revenues dedicated exclusively to housing activities.

- **Metropolitan Council's Local Housing Incentives Account** is money provided through the Metropolitan Council's Livable Communities Act.

Non-Profit Sources

- **Family Housing Fund** is a nonprofit agency that operates in the seven-county Twin Cities metropolitan area and provides capital funding (grants and loans) to affordable housing projects. Contributions from the McKnight Foundation and corporate donations finance the fund.

- **Greater Minnesota Housing Fund** is also a nonprofit agency that provides capital funding but operates in outstate Minnesota. Contributions from the McKnight and Blandin Foundations finance the fund.

SOURCE: Office of the Legislative Auditor.

TAXES

Property taxes are an important revenue source for local governments. But, property taxes on rental housing have a significant effect on rents that property owners charge. According to the Department of Revenue and the Institute for

Funding from two federal grants, the HOME and Community Development Block Grant programs, have been the most widely used funding sources.

Table 2.10: Percentage of Local Housing Organizations that Used Various Funding Sources, 1999

Source	Percentage of Local Housing Organizations
Federal	
Community Development Block Grants/Small Cities Development Program	50%
Federal HOME funds	37
Low-income housing tax credits	19
Federal Home Loan Bank	14
State	
MHFA Community Revitalization Fund	34
MHFA Rental Rehabilitation Program	20
MHFA Housing Trust Fund	17
MHFA HOME Rental Rehabilitation Program	16
MHFA Affordable Rental Investment Fund	13
MHFA Low and Moderate Income Rental Program	5
MHFA Affordable Rental Investment Fund—Preservation	3
Other MHFA programs	29
Local	
Tax increment financing	23
Local tax levy	16
Local bonds	15
Metropolitan Council Local Housing Incentives Account	11
Local housing trust fund	9
Private, Nonprofit	
Greater Minnesota Housing Fund	20
Family Housing Fund	16
Other	38

NOTE: We asked local housing officials, "Which of the following financing tools did your organization use in 1999 to assist in the development, construction, or rehabilitation of affordable housing in Minnesota?" $N = 149$.

SOURCE: Office of the Legislative Auditor's survey of local housing officials, July and August 2000.

Real Estate Management, property taxes constitute about 14 percent of rent collections in Minnesota.[81] Thus, it is somewhat surprising that taxes were not a major concern of most survey respondents, as shown earlier in Tables 2.1 and 2.2.

When survey respondents did identify taxes as a factor that limits the production of affordable housing, they cited property taxes on rental housing the most often as an example. One developer wrote, "[Property taxes are] perhaps the most significant impediment to developing [multifamily] housing. [Minnesota's] property tax system imposes a heavy burden on multifamily housing, thus reducing debt that can be supported and negatively impacting financial feasibility." Another developer stated, "As a national developer we see [a] per unit [tax] that rates among the highest in the U.S. in Minnesota."

81 Minnesota Department of Revenue, *Analysis of Rent and Property Tax Data from Landlord Rental Property Tax Form LRP* (St. Paul, May 1994), 3; and Institute for Real Estate Management, *Income Expense Analysis: Conventional Apartments, 1999 Edition* (Chicago: Institute for Real Estate Management of the National Association of Realtors, 1999), 92-93.

A recent task force identified property taxes as a significant impediment to affordable housing.

In fact, an affordable rental housing task force, made up of local housing experts, recently identified property taxes on rental housing "as a very significant, perhaps the most significant, impediment to building needed apartments." According to the task force, developers of moderately-priced apartments cannot attract investors because property taxes are too high to make the project financially feasible. Consequently, virtually all apartments being built in Minnesota are either government subsidized housing or luxury apartments for which rent is sufficiently high to pay property taxes.[82] Indeed, as we showed at the end of Chapter 1, production of multifamily housing is currently relatively low.

The finding that most respondents did not cite property taxes as a significant impediment may be explained by two factors. First, although 105 developers and builders of multifamily housing completed our survey, it is likely that many of them only built owner-occupied housing, such as townhomes. The possibility that relatively few developers and builders of rental housing completed our survey may explain the low number of respondents identifying property taxes on rental property as a problem.

Second, developers, builders, and local housing organizations only pay property taxes while they own the property, typically while the housing is being developed and built. If we had surveyed owners of rental housing (the ones who pay property taxes), they may have cited taxes as a significant limitation more frequently. Indeed, a national survey of property owners cited property taxes as their number one concern.[83]

Nevertheless, it is evident that:

- **Minnesota has a relatively high tax rate on rental property.**

In 2000, the average effective tax rate on apartment buildings in Minnesota was 2.1 times greater than the rate on homesteads (owner-occupied housing). On average, owners of apartment buildings paid 2.85 percent of their properties' assessed market value in taxes, while owners of homesteads paid only 1.37 percent.[84] In addition, based on a $600,000 building, Minnesota had the third highest effective tax rate on apartments in the country in 1998. In contrast, the state had a typical tax rate for homesteads—its rank ranged from 18th to 26th depending on the value of the home.[85]

But in recent years:

- **The state has taken steps to lower taxes on rental property.**

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82 Affordable Rental Housing Task Force, *Affordable Rental Housing: Opening Doors for Private Development and Preserving Existent Housing Stock* (January 2000), 5-6.

83 Howard Savage, *Current Housing Report: What We Have Learned about Properties, Owners, and Tenants from the 1995 Property Owners and Managers Survey* H121/98-1 (Washington D.C.: United States Department of Commerce, Economics and Statistics Administration, October 1998), 1.

84 Office of the Legislative Auditor analysis of data from Minnesota House of Representatives Research Department, *House Research Issues & Information: Property Tax: Changes in Property Tax Burdens Since 1991* (St. Paul, 2000).

85 Minnesota Taxpayers Association, *50-State Property Tax Comparison Study: Payable Year 1998* (St. Paul: Minnesota Taxpayers Association, January 1999), iv.

Rental property's share of all property tax collections has declined.

The rate at which Minnesota taxes property is based on a combination of state and local policies—local property assessments, local tax rates, state class rates, and state tax credits. Table 2.11 provides details on calculating property taxes. Class rates are one of the state's main mechanisms for distributing property taxes among different types of property, and Table 2.12 shows the 1991 and 2000 class rates for standard residential properties. During this period, the state reduced the class rates on apartment buildings with four or more units by 33 percent and even more for buildings with less than four units. Because class rate reductions for rental properties were greater than other types of property, apartment buildings' share of all property tax collections declined from 8 to 6 percent, while the share for buildings with less than four units dropped from 7 to 3 percent.

Table 2.11: Calculating Property Taxes

Property Taxes Owed = (Assessed Value x State Class Rate x Local Tax Rate) - State Tax Credits

- The state sets the class rates, which ranged from 1.0 to 2.4 percent for standard residential properties in 2000.
- Local governments (a combination of cities, counties, school districts, and special taxing districts) set the local tax rate, which averaged 126.8 percent in the Twin Cities' metropolitan area and 138.5 percent in outstate Minnesota in 1999.
- The state also establishes tax credits. The broadest one is the education homestead tax credit, which lowers the tax on homesteads by 83 percent of general education's portion of the local tax levy. The maximum credit is $390 per homestead.

SOURCES: Minnesota Department of Revenue, *Minnesota Tax Handbook: A Profile of State and Local Taxes in Minnesota* (St. Paul, March 1999); and Citizen's League and Minnesota Taxpayers Association, *Minnesota Homestead Property Tax Review 1999* (St. Paul: Minnesota Taxpayers Association, October 1999).

In addition to the class rate reductions, the state created a new property class (4d) for lower-income rental housing that became effective in 1999. As shown in Table 2.12, the class rate on 4d properties is 1 percent of a property's assessed value, which is 17 to 58 percent lower than the rate on other rental property. For rental property to qualify for the lower tax rate, tenants' incomes cannot exceed 60 percent of the median family income, and rents cannot exceed 30 percent of the income limit.[86] For 2001, property owners have designated 82,063 rental units under the 4d class in Minnesota, which is 16 percent of all rental units in 1990 (the most recent available data). Of these 4d units, 58 percent are in compliance because they participate in other government programs (project-based Section 8, low-income housing tax credits, Rural Housing Service rental assistance, and MHFA Rental Assistance) with similar or more stringent income and rent requirements. The remaining 42 percent are market-rate units that property owners have pledged to the program.[87]

86 *Minn. Stat.* (2000) §273.126, subd. 2 and 3.

87 Minnesota Housing Finance Agency data on the class 4d program; and United States Bureau of the Census, *1990 Census of Population and Housing,* Summary Tape File 1, Matrices H1, H2, H5, P1 GEO, http://wwwfactfinder.census.gov/java_prod/dads.ui.homePage.HomePage; accessed December 20, 2000.

Table 2.12: Residential Property Tax Class Rates, 1991 and 2000

Class	Description	1991 Class Rates as a Percentage of a Property's Assessed Value	2000 Class Rates as a Percentage of a Property's Assessed Value
1a	Residential homestead (owner-occupied)		
	First Tier (applied to the first $68,000 of assessed value in 1991 and $76,000 in 2000)	1.00%	1.00%
	Second Tier (applied to the portion of assessed values between $68,000 and $110,000 in 1991 and greater than $76,000 in 2000)	2.00	1.65
	Third Tier (applied to the portion of assessed values greater than $110,000 in 1991)	3.00	N/A
4a	Rental property with four or more units	3.60	2.40
4b	Rental property with two or three units	3.00	1.65
4bb	Rental property with one unit		
	First Tier (applied to all values in 1991 and the first $76,000 in 2000)	3.00	1.20
	Second Tier (applied to the portion of assessed values greater than $76,000 in 2000)	N/A	1.65
4d	Qualifying low-income rental housing	N/A	1.00

NOTE: N/A means not applicable.

SOURCES: Minnesota Department of Revenue (DOR), *Addendum to the 1998 Edition of the Minnesota Tax Handbook* (St. Paul), 5; and DOR, *Property Taxes Levied in Minnesota: 1990 Assessments, Taxes Payable in 1991* (St. Paul, 1990), 4-7.

The 4d program is intended to encourage property owners to lower rents or build more affordable housing. However, we found that:

- **In the Twin Cities metropolitan area, rent limits for the 4d low-income housing program were actually higher than the average market-rate rents for efficiencies and one- and two-bedroom units for 2000.**

The "4d low-income program" provides tax breaks to property owners making a long-term commitment to affordable housing.

Table 2.13 shows the rent limits and average rents. Since much of the rental housing that meets the 4d rent limits does not take advantage of the lower property tax rates, it is unclear whether the new property class is stimulating much more affordable housing. Several program requirements may inhibit property owners from participating. First, tenants must meet the specified income limits. Second, property owners must commit to the income and rent limits for five years. Third, property owners must make a portion of the units available to Section 8 certificate and voucher holders. Finally, the units must be inspected every three years.[88] The program only provides tax benefits to those who are willing to make a long-term commitment to affordable housing.

88 Minnesota Housing Finance Agency, *2000 Application for Minnesota 4d Property Tax Classification* (St. Paul), 2.

Table 2.13: 4d Rent Limits and Average Rents in the Twin Cities Metropolitan Area, 2000

Number of Bedrooms	4d Rent Limits	Average Gross Rents
0	$ 690	$ 527
1	739	715
2	886	876
3	1,025	1,140

NOTE: Gross rents include rent payments and tenant paid utilities. To calculate average tenant utility payments, we obtained from Apartment Search the percentage of apartment buildings in which tenants pay each of the major utilities. We then applied these percentages to the Metro Housing and Redevelopment Authority's utility allowance.

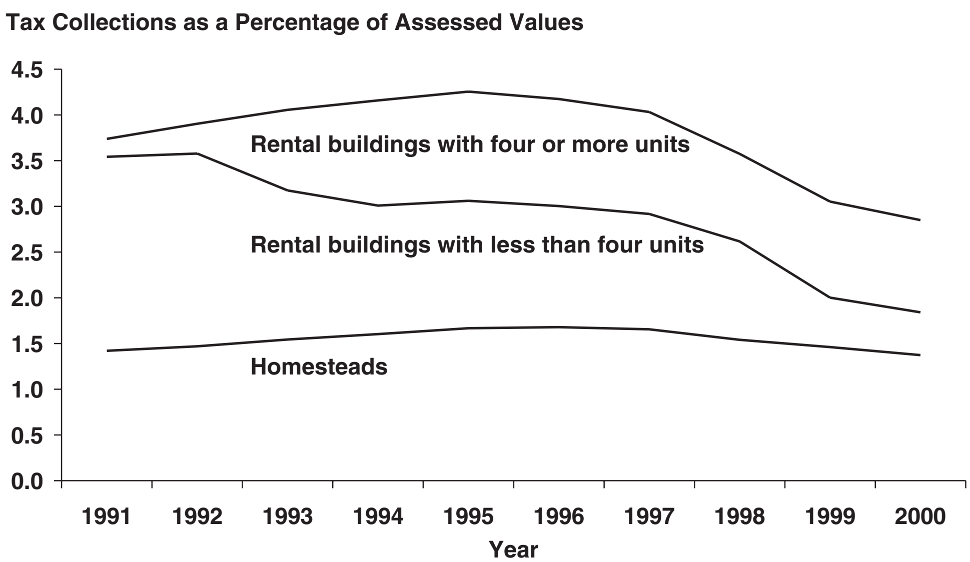
SOURCES: Minnesota Housing Finance Agency, *4d Rent Limits for 2000,* http://www.mhfa.State.mn.us/pages/4Dtax/rentlimit.htm; accessed on July 26, 2000; Apartment Search, *Profiles 2000 Quarterly Review,* (Edina, MN: Apartment Search, 2nd Quarter 2000); and Metro HRA, *Existing Housing Allowance for Tenants—Paid Utilities and Appliances* (St. Paul, July 2000).

We found that:

- **The reduction in class rates contributed to a significant decline in the effective tax rate on rental housing.**

As shown in Figure 2.7, the average effective tax rate (taxes paid divided by assessed market value) dropped from 3.74 percent in 1991 to 2.85 percent in 2000 for apartments with four or more units and from 3.54 to 1.84 percent for buildings

Figure 2.7: Effective Property Tax Rates in Minnesota



SOURCE: Office of the Legislative Auditor's analysis of data from Minnesota House of Representatives Research Department, *House Research Issues & Information: Property Tax, Changes in Property Tax Burdens Since 1991* (St. Paul, 2000).

with less than four units. In fact, even without adjusting for inflation, the total amount of taxes collected in Minnesota from rental properties declined although the aggregate market value of these properties increased. Tax collections from apartments declined 2 percent, while their aggregate market value increased 28 percent. Collections from buildings with less than four units declined 36 percent, while their aggregate market value increased 22 percent. In comparison, the effective tax rate on homesteads declined slightly, from 1.42 percent in 1991 to 1.37 percent 2000.[89]

Equalizing the tax rates on rental properties and homesteads has long been discussed in Minnesota. We estimated that:

- **Average rents would decrease by about 7 percent if the effective tax rate on rental income were cut in half to equal the homestead rate and *if* property owners passed all the savings on to renters through lower rents.**

As mentioned above, about 14 percent of rent collections go to pay property taxes. Consequently, if property taxes were cut in half and all the savings were passed on to renters, property taxes would account for only 7 percent of rent collections. This would constitute a 7 percent decline in rents. However, it is not entirely clear as to when and how much of a property tax reduction would be passed on to renters.

A Department of Revenue study assumed that in the long run property taxes savings are passed on to renters.

Since 1993, the Department of Revenue, in its biennial study on the incidence of taxes in Minnesota, has assumed that almost all changes in property taxes are passed on to renters in the long run.[90] The basic premise behind the department's assumption is that money moves to where it earns the highest rate of return. Consequently, it is assumed that if Minnesota lowers its tax on rental property, the following chain of events would occur:

1. Profits earned from rental properties would rise as tax expenses decline;
2. To take advantage of the higher rate of return, more people would invest in rental housing in Minnesota;
3. As the investment in rental housing increases, the supply would increase;
4. As the supply of rental housing and vacancies increase, property owners would compete to fill their units by reducing their rents;
5. As rents decline, profits would decline; and
6. Finally, the chain of events would stop once the decline in rents equals the decline in property taxes and the rate of return of investing in rental housing is back to its original level.

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89 Office of the Legislative Auditor analysis of data from Minnesota House of Representatives Research Department, *House Research Issues & Information: Property Tax, Changes in Property Tax Burdens Since 1991* (St. Paul, 2000).

90 Minnesota Department of Revenue (DOR), *1999 Minnesota Tax Incidence Study: Who Pays Minnesota's Household and Business Taxes* (St. Paul, March 1999), footnote 29 on page 48; and Paul Wilson (author of DOR report), interview by author, St. Paul, July 3, 2000.

In the short run, property owners have little incentive to pass tax savings on to renters.

However, in the short run, before the supply of rental housing increases, owners of rental housing have little incentive to pass any property tax savings on to renters, especially when the vacancy rate is well below 5 percent. Because there is such a high demand for rental housing, owners could keep all the savings from lower property taxes and still fill nearly all their units. In addition, factors that limit the production of rental housing, such as the supply of land, may prevent the market from fully adjusting to the lower property taxes by increasing supply.

In any case, we do not have any empirical evidence to show what is likely to happen if the state lowers taxes on rental property. In addition, lowering taxes on rental property would cause local governments to lose revenue. To make up for the loss, local governments would need either to increase the local property tax rate on all classes of property or to receive additional aid from the state. If local governments increased their local tax rate, homeowners and businesses would pay higher property taxes. If the state provided additional aid, it would have to raise taxes or take funding from other programs.

COMMUNITY OPPOSITION

We found that:

- **Community opposition to affordable housing—commonly known as "not in my backyard" (NIMBY)—appears to be a bigger limitation for multifamily than single-family housing.**

As shown earlier in Tables 2.1 and 2.2, a majority of developers of multifamily housing in our survey cited community reaction as a significant limitation to the production of new affordable housing. For example, a nonprofit housing agency commented in its survey, "Homeowners in every neighborhood object to 'those people' coming into their neighborhoods (minorities, low-income)." In addition, a developer wrote, "If there is a negative reaction from the community, it will deter developers from proposing a project or development."

People appear to support the concept of affordable housing in theory. In a recent survey, the Metropolitan Council found that 89 percent of residents in the Twin Cities area believe that all cities should have some affordable housing and that people should be able to find affordable housing near their workplace. In addition, 59 percent of residents said that low-income housing is not an important cause of neighborhood deterioration and crime when it is mixed with middle- and upper-income housing.[91] This acceptance of affordable housing is supported by a recent study by Maxfield Research (a market research firm) that examined the effect that housing financed with low-income housing tax credits had on surrounding property values in the Twin Cities area. It found that:

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91 Metropolitan Council, *Report to the Minnesota Legislature on Affordable and Life-Cycle Housing* (St. Paul, December 1999), 30-31.

> The homes that were sold in the subject areas around 12 tax-credit developments…, in general, displayed *similar or stronger market performance in the period after the tax credit properties were built*, as well as *similar or stronger performance to comparable homes sales from a control group* (emphasis in original).[92]

Nevertheless, there is often vocal opposition to affordable housing. According to the developers and representatives of local housing organizations that we interviewed, people often associate affordable multifamily housing with negative stereotypes of public housing—large, unattractive buildings riddled with crime and drugs. They fear that their neighborhoods and property values will decline. In addition, some people do not like any growth or change in their neighborhoods, regardless of whether it is affordable housing or a high-end development.

Profit-minded developers are often unwilling to devote resources to fighting community opposition.

In some cases, it takes years of meeting with city and community officials to build acceptance and support for a project. For example, CommonBond Communities (a nonprofit developer) recently built 19 affordable rental townhomes in Maple Grove. It took the developer three and one-half years to complete the project. It spent the first two years getting the city council's approval and breaking down the NIMBY attitude of the residents. CommonBond obtained the acceptance of city officials by showing them some low-income housing that it built in Edina, which counteracted negative stereotypes of affordable housing. CommonBond then worked with churches, businesses, immediate neighbors, civic leaders, and organizations to build community support. Even with all the groundwork to build community support, the final public hearing about the project before the city council was overflowing and rancorous. It is unclear if developers are only confronting a vocal minority or if people's attitudes change when affordable housing is actually in their neighborhoods. In any event, profit-minded developers are often unwilling to devote resources to such an effort.[93]

CONCLUSION

Developers, builders, and local housing organizations cite many factors that potentially limit the production of affordable housing. As we note in this chapter, governments created many of these potential impediments to achieve other valid policy objectives. For example, zoning ordinances allow local governments to develop their communities based on local priorities. The Metropolitan Council uses the MUSA to encourage compact, orderly development in the seven-county Twin Cities area. Municipalities use property taxes and development and construction fees to pay for local services. Finally, the building code ensures that housing is safe and well constructed. If policy makers at all levels decide to address any of these potential impediments, they must balance these objectives with the goal of reducing housing costs.

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92 Maxfield Research, *A Study of the Relationship Between Affordable Family Rental Housing and Home Values in the Twin Cities: Summary of Finding* (Minneapolis: Family Housing Fund, September 2000), 2.

93 Joe Errigo (CommonBond Communities), telephone interview by author, October 5, 2000.