



The Missing Middle Sinkhole, Presentation at Inland Northwest Partners Spring Conference

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Introduction

Why a “sinkhole”? Because all the things we’ve talked about today in terms of middle density housing are basically not having any effect on affordability, so far. But the question is why? And will it get better?

We will first go through where we are in the history of US housing development and then discuss what you as local leaders and elected officials can do about it. I will warn you, at points, you will think I’m a libertarian. I am not, but libertarians are not always wrong. And, if I talk like one it’s to get us to reflect on our history and how it has contributed to our current situation.


Housing affordability is a disaster in our country. At some point we need to examine whether what we are doing is working or not. I see the issues with housing touching on both market and regulatory issues. In other words, the regulatory tools will have some intended and unintended consequences on how the market responds. The best forms of policy will have the most fair and equal application of the law to all, and create space for the private sector to solve problems while people make a reasonable profit. I submit that if we expect the problems to be solved without anybody making any profit, we are part of the problem.

Before we get into all of that I want to mention a few fundamental questions we will be orbiting around during this discussion. Though I don’t have all the answers on these things, it is important that we ask questions because it will help challenge our existing assumptions on these issues:

- How much say should individual land-owners have over the use of property that is adjacent to, but not owned by them?
- Are our recent policy changes in favor of “middle density” housing having the desired effect on affordability?
- Is local government using the right “tools” to move public opinion on density?
- Are the solutions to our local housing challenges going to come from those already in our communities, or from large scale developers?
- Are top-down or local policies going to have the greater effect on housing and affordability in our rural communities?

Policies & Tradeoffs

So, think on those things while I go on. On the point of government policies, I like to quote one of the best economists of the 20th century, Thomas Sowell. He said: “In economics, there



are no solutions, there are only trade-offs." *Welcome to the dismal science my friends!* But, in honesty, there is so much wisdom in what Sowell is saying. We really need to listen to it. If you cannot control the market and means of production from top to bottom, you can only manage a small portion of the incentive structure, not how the market responds to that. (And I'd venture to guess that all of us here are sensible enough to see the problem with giving the government full control over means of production). Therefore, when we create housing policy designed to force an outcome, like development of more affordable units, for example. We often get some mutation of that or even the exact opposite.

For example, let's say, that a city legislates that no new market-rate rentals can be built without X% of "affordable" units being included in the mix. Surely, we've all seen or heard of such policies at some point. *For example, for every 20 units, 5 need to be affordable.* Now in a place where the market is very hot, you can get away with this. The profit motive and incentive structure is strong enough to handle it. But in an average market, guess what happens? Not only do not get the affordable units that the policy was intended to create, but you get less market rate units to boot. To make matters worse, now that supply is more limited, you risk the market rate for apartments going even higher for everybody!


Let me quote another one that I heard recently. In response to gentrification and rent evictions, certain cities in Oregon are now legislating that short-term rentals need to be separated by at least a 500-foot radius. Maybe they partially accomplished the goal of maintaining the rental stock from diminishing. But, what is the broader unintended consequence? The government just made a couple people a whole lot richer. The value of 4-5 homes per neighborhood, occupied by early responders, just jumped by about \$100K. Perhaps that new constraint and timeline even forced some owners to rush to convert a unit to STR before their neighbor does.

The argument here is not to not regulate anything. Regulation is often necessary (*see I told you I'm not a libertarian*). But, we need to think holistically about these issues and observe where we may be creating "deadweight loss" (economist term for under production) and other unintended consequences. This also gets to a point that I want you to think about related to regulation as well. It often lacks vision and creativity. We cannot make policies assuming that the market will be inert (or unmoved) by changes in policy. We really need to put ourselves into the shoes of the market actors to know what will incentivize and de-incentivize action.

History

The first issue we need to acknowledge is that the practice of zoning is, and always has been, an artificial restriction on supply. Not just on residential but on all forms of land-use. What I mean by that is that the *free market* cannot be the ultimate determiner of a property's highest and best use because a zoning code with inbuilt restrictions is plastered over the top of that property. Therefore, it is at least theoretically possible that the "highest and best use" will never be found if that use is categorically disallowed.

The argument for zoning stems from several economic theories which we will not go into in detail. But essentially, the belief is that without zoning we'd all be subject to the chaos and



negative externalities of pollution, traffic, unattractive landscapes, and any number of other things that would drive planners crazy. A simpler argument would simply be that when it comes to land use, the whole is greater than the sum of the parts. In other words, the market could not actually find the optimal solution because the optimal solution requires a level of planning that cannot be done at a micro-level.

Now we start to see some of the ironies of central planning, however. Much of the new urbanist movement is about blurring the lines between the highly discrete districting according to residential, commercial, industrial uses. When bodegas and eateries opened up in proximity to apartments and townhomes in downtown New York in the early 20th century, it wasn't because a planner had a bright idea. It was because that is what people wanted.

Historically, those in single-family neighborhoods have had their thumb on the scale in terms of preferred land-use. There was a famous case in Euclid, Ohio in 1926, which went all the way to the Supreme Court. The City of Euclid developed zoning code mainly to prevent the encroachment of industry from neighboring Cleveland that was rapidly expanding outward. There was also an element of protecting from multi-family housing as well. Taken directly from the Court's opinion: a hypothetical apartment in the City is "a mere parasite, construction in order to take advantage of the open spaces and attractive surroundings created by the residential character of the district."¹ The Supreme Court ruled in favor of the City, and here we are 100 years later and you can scarcely find a single city in the country with no zoning (except Houston). Can you see some of those same sentiments at play in our current discussions around NIMBY-ism?

Only recently, as in the past twenty years, with rapidly escalating housing costs and relatively stagnant wages, has it dawned on policy makers that we may need to alter land use in order to change the incentive structure around housing.

New Top–Down Legislations


So here we are in a new era and those of us living in the Pacific Northwest have a front-row seat to these changes, especially the top-down policy fixes being implemented in ours and neighbor states.

Washington is considering HB 1110 which will require increased density for all cities exceeding 6,000 residents at increasing levels of density in terms of community size. I suspect it will pass. If not this year, then a year soon to come.

Oregon passed HB 2001 into law in 2019 and it took effect in 2020. The bill affects towns differently based on size. For towns 25K and larger duplexes, triplexes, fourplexes and cottage clusters are required to be allowed in all single-family zoning districts. In smaller towns, duplexes are ushered in but not the denser options. Though passed several years ago, the implementation is still being rolled out. The strongest aspects did not take effect until summer of 2022. It's too soon to tell what will happen here.

Perhaps it is helpful to look for guidance to districts that are a few steps ahead of us. California implemented SB9 in 2021. A 2021 analysis found that 700K homes would become

¹ The Practice of Local Government Planning, 2nd Edition, ICMA.



feasible that were previously not.² In theory, this could have a huge impact. In short, so far the results are underwhelming. An analysis of selected communities found that in Los Angeles just 211 applications for units that were previously unallowable (out of 20,000); clocking in at roughly 1%. That was the highest impact of any city. In San Diego, just 7 of 5,000 applications were permitted that would have previously not been allowed.

Now, there are several factors hear to account for. Obviously, there was the long-tail of COVID (especially in California). Secondly, more recent hesitations about the housing market are holding some people back. So, these numbers will tick upward. The market needs to be right, people need to learn how to use it, and sometimes the policies require some fine-tuning, that is really best done at the local (and not the state) level.

Perhaps we just need to allow time for these changes to take root. It is interesting to note that in 1975 roughly 40% of new home construction was for homes 1,400 SF or smaller. As of 2020, that number is 7%. In other words, we have not always been a nation composed solely of large single-family homes. In my experience, builders do what they do and are confident they can make money doing. And, give them some credit, if they've been at this more than 10 years they have seen more than a few of their friends go bankrupt doing risky things. They are also working against the systematic grain that we previously discussed (insurance, financing, planning, etc.). The most likely people to take steps are those that are native to the new reality.

The Next Stage of Solutions

At this point you are probably thinking, okay Brian enough negativity, can you give us something positive? I can. And I am actually hopeful about where we are at this stage in the lifecycle as we learn from our initial efforts. Look how far we have come. Consider the fact that 10-years ago most people in this room had never heard of terms like "accessory dwelling unit", "R2" and "quadplex" (unless you were an architect or planner). Now, most of us do and some of us talk about these topics regularly. In the next stage of solutions there will be some more terms for us to take in, so get ready for that.

The Turner Center for Housing Innovation (at Berkeley) had a great report released in 2022. The reason it is great is that they directly asked about 20 builders across the country who are really working on these projects (sometimes successfully and sometimes not). Here are some of the key takeaways, with my commentary intermixed:

Its not just about zoning, it's also about alignment of other development code. Many municipalities have already taken the first step to allow duplexes or ADUS, for example. But there is other code on the books that limits the building area. This touches on issues such:

- Front, rear, and side setbacks
- Building heights
- Floor area ratios (or FAR)

² "California's HOME Act Turns One: Data and Insights from the First Year of Senate Bill 9", Turner Center for Housing Innovation, <https://turnercenter.berkeley.edu/research-and-policy/sb-9-turns-one-applications/>

- Parking requirements
- Water/sewer meter requirements
- Unrelated individuals allowed to live together (one of the most ridiculous ones, in my book)

Let's make these examples a bit more concrete. Imagine a standard parcel in an R2 district with 7,500 SF (less than 0.2 acres). If allowances are made for duplexes where they weren't previously, and no adjustments are made on set-backs, builders are now trying to squeeze two living units where there was previously one, and still allowing space for parking, buffers, street easements, etc. Not an easy task.

Another local example, City of Moscow started allowing ADUs around 2015. There was a little movement but adoption was limited. After asking builders and citizens for more input they concluded that building lot sizes and metering requirements were preventing adoption, so they loosened these standards in 2019.³ These can be especially impactful in city's with "hot" markets. In 2019 the City of Boise made three seemingly marginal changes: ADUS from max of 600 SF to max of 700 SF; max bedrooms from 1 to 2; no parking requirements for 1-bedroom units. The results: FY19: 33 units; half of FY20: 94 units.⁴

A third element is that it is time to take seriously is whether we mean it when we say that attainable housing is a "priority." The National Association of Home Builders survey shows that for builders 4.9% costs go toward various fees and permits.⁵ That is roughly the same cost of insulation and drywall combined. Not only that, but more complicated projects like cluster housing, will have to pay extra fees for architectural reviews, PUDs, CUPs, etc. So we are actively *discouraging* the type of development that we all admit to wanting more of. I'll also point out that Impact Fees generally did not exist until the 1930s and really didn't become common place until the 80s/90s.⁶ Prior to that development costs were absorbed by the entire community. Is it really so crazy to propose going back to such an approach, especially when communities are seeing so many downsides to the lack of affordable housing?


We cannot pretend that fees and processes do not have an impact on developers' business model. We also would be foolish to think that it's coming out of the pockets of developers- it's passed directly through to the residents in form of mortgage or rental costs. This also

³ Moscow softens requirements for parking, accessory dwellings, Daily News, https://dnews.com/local/moscow-softens-requirements-for-parking-accessory-dwellings/article_d8d97b00-54e3-53b3-b4f4-4a354c79e756.html

⁴ "ADUs gaining popularity in Boise since regulations relaxed last year", BoiseDev, <https://boisedev.com/news/2020/10/28/adus-gaining-popularity-in-boise-since-regulations-relaxed-last-year/>.

⁵ Cost of Constructing a Home, 2022, NAHB, <https://www.nahb.org/-/media/NAHB/news-and-economics/docs/housing-economics-plus/special-studies/2023/special-study-cost-of-constructing-a-home-2022-february-2023.pdf>.

⁶ "Impact Fees & Housing Affordability" HUD, <https://www.huduser.gov/periodicals/cityscape/vol8num1/ch4.pdf>.



doesn't account for delays caused by inspections not getting done, public meetings occurring very infrequently, changes in requirements from city planning, etc.

One client we are working with requires all permits to be signed off by P&Z, City Council, and an additional "Fiscal Court" and the P&Z committee only meets once a month (excluding December). Imagine your business was constrained by getting that level of permission from an organization that only meets 11 times per year! These people are borrowing money to get these projects done. Every day costs them. Now, I know cities have staffing shortages and I am not saying they need to be working overtime just to fix these problems.

But, again, can we think more creatively about fixing some of these issues? A few ideas on that front:

- Most impact fees are either fixed-cost (same cost regardless of scale), or are variable based on square footage. Why not award any form of priority buildings (such as infill)? After all, infill is typically less burdensome on the infrastructure systems than greenfield development and therefore less cost to the community. What about deferred payment for those meeting partial criteria?
- Can priority projects (density, infill, ADUs, affordable) "jump the line" in front of others following a more standard SFH process?
- In cities of adequate size, set aside a permitting team for middle-density so they can stay focused and work more quickly through the process.

Lastly, we must also acknowledge that problem here is not just *regulation* or just the *developers*. It's systematic. Even builders who want to do something unconventional and have the correct zoning in place, can have a hard time with both investors and banks. Investors can always make more money doing a tried and true project at a bigger scale. The investors they draw are those with some form of dual incentive, like community development and profit, for example. Those type of people generally do not come from 500 miles away. They are the people who already know how to build and are already in your town.

This is yet another of the brilliant observations from the Turner Center report. Big institutions do not like risk and they do not like small projects. The missing middle developers interviewed rely mostly on local capital that is willing to take on the risk for other reasons. To quote one participant, Eli Spevak: "[Investors] want to have their money in something tangible, that they can see in the neighborhood that they can point to... even though people can make better returns investing elsewhere, and they know that. But they still do it."

Where will we go from here?

- It will get worse before it gets better. The combination of inflation, housing shortages, labor shortages of trades workers, and many other factors do not bode well in the short term. But, the cooling market and the maturation of the "missing middle" market will gear up slowly over the next 10 years.
- More "top down" regulation from states; in time, these will have notable effects in urban areas. In rural areas, they will make little difference, but they will force steps that will be helpful.

- More incremental legislation from mid-sized towns
- Finding the “sweet spot” for the right type of developers; metros the size of Boise and Spokane will develop their own roster of “missing middle” operators who know how to make a profit doing it. But will it filter into Rathdrum, Sandpoint and Moses Lake without a lot of extra effort? That remains to be seen.
- The US faces the specter of population decline for the first time in our history. At this rate it’s not a guess it’s a given. Our states are more insulated due to huge levels of immigration, but it’ll still hit us in the smaller towns. At that point, unoccupied structures will actually become one of the biggest issues that some of our smaller communities are facing.

What can your community do?

- Do a housing needs analysis! (shameless, I know), but really this can have a number of positive impacts. To name a few:
 - help clarify where the biggest gaps are (not always the same in each community)
 - get a baseline for where the community is for tracking progress on priority issues
 - “activate” and draw attention from the private sector
 - It can help “nudge” the community rather than forcing change upon them. Frankfort KY our housing market study is structured to say “in which neighborhoods or areas of town would these housing types be suitable.” Artists renderings are provided of ADUs, townhomes, etc. They can select “none” but it is still a form of education and exposure to new concepts.
- Assign more “homework” to the City Council and P&Z related to these topics (like the Turner study I quoted earlier). Look at “pre-approved” ADUs and cottage developments developed by municipalities in your state (such as Seattle).⁷
- Once you understand it, make it easier for the building community. Create one-sheets, infographics, recommended building plans, etc. For those who see the demand and the new context we are in, they will find a way to respond.

In summary, now is the time for examining your policies and practices and finding a new way to fill the missing middle sinkhole. Some specifics for each party in attendance:

- Elected officials and staff: do your homework; find ways to push feasibility of missing middle into the corners
- Builders: find the new angle to file the gaps in this new policy framework
- Financial institutions: they can’t do it without you! Get your staff and underwriters to understand new models so they can finance them
- Community/Economic Development: lead by talking about it; facilitate connections between capital, builders, investors and business owners

⁷ ADUniverse, <https://aduniverse-seattlecitygis.hub.arcgis.com/pages/gallery>.