

OFFICE DEVELOPMENT LINKAGE IN SAN FRANCISCO

Exacting the Social Costs of Growth

by

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Abstract

This thesis outlines the theory and practice of office development linkage in San Francisco, where linkage was originated to ameliorate rising house prices and lack of affordable housing. Linkage has evolved out of the exactions developed in response to trends away from public financing of the costs of growth and development. This thesis concludes that linkage as an economic mitigation unfairly targets one minority (office developers) as an identified troublemaker, allowing others (homeowners for instance) to be free riders during periods of regional economic growth. The paper also suggests that linkage, as a political solution, has engendered a public perception that effective action has been taken, even though the underlying economic problems continue unabated, and thus linkage stills debate on issues of political economy.

In discussing linkage this paper tells three interwoven stories: the theory and evolution of linkage from exaction to econometrically justified social program; the history of the politics and practice of linkage in San Francisco; and an analysis of the economics affecting San Francisco, which reveals that the problems linkage seeks to mitigate are region-wide. This leads to two conclusions: that in focusing on office developers, linkage in San Francisco is failing to deal with the larger structural problems of regional economy, and that linkage leaves as free riders the rest of those who benefit from growth, most clearly other property owners, including homeowners.

Finally it is suggested that for an effective or fair policy, other avenues must be explored, and public debate about common responsibilities must be revived. It is suggested that linkage be further rationalized through economic land profit models, and that there may be a need for transfer taxes on the sale of real estate, also based on land profit models, to recapture the windfall profits of growth.

Thesis Advisor: Doctor Langley Keyes

Title: Professor of Urban Planning

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INTRODUCTION

Overview

This paper examines the theory and practice of “development linkage” -- the policy of requiring commercial developers to finance housing, social services, and public amenities in return for permit approvals.¹ The setting for this examination is San Francisco, California, where, in 1981, linkage payments for construction or renovation housing were instituted. At that time the real estate market was robust, and politically linkage appeared to solve housing availability and affordability problems imputed to commercial sector growth. Subsequently, the office development market has been constrained by local politics and national economic events, with the result that linkage funding for housing and social services has diminished.

In discussing linkage this paper tells three interwoven stories. The first is the evolution of the theory of linkage, told through the political and legal background of the land-use zoning and development exactions from which linkage arose. The second story is the history of the politics and practice of linkage in San Francisco, where linkage originated and evolved. The last story in this trilogy is an analysis of the economics affecting San Francisco, and the relationship of these macro-economic changes to linkage.

¹Dennis W. Keating, “Municipal Downtown Commercial Development Linkage Policies: A Case Study of Developer’s Opinion of San Francisco’s Office Housing Production Program and Transit Impact Development Fee.” Conference paper from Linkage Forum co-sponsored by the U.S. Conference of Mayors and the Urban Land Institute. New York, 1985

These stories lead to a conclusion that linkage, by focusing only on office developers to mitigate problems, leaves other property owners (including homeowners) who benefit economically from growth out of the mitigation discussion. By not addressing the problems of growth directly, policy makers may have missed an opportunity to stimulate public debate on the economic structural issues which have made home ownership and rental more difficult for lower and middle income groups. As a political vehicle linkage goes after the people who obviously have money, and focused on this easily targeted minority, linkage may have relieved pressure on the public to effectively deal with problems of regional growth and housing affordability, and thus may have helped the public evade a responsibility.

Finally the trends delineated in this paper suggest that linkage is a viable means for providing a small amount of housing and services. But as practiced, linkage is inequitable and inefficient; for an effective and fair policy, other avenues must be explored, and public debate about common responsibilities must be revived.

This paper is organized by the themes discussed above into three chapters. Chapter One is the theory and evolution of linkage. Chapter Two is the history and practice of linkage in San Francisco. Chapter Three is a critical review of linkage, looking at implicit assumptions and economic models which help explain the policy of linkage in the context of San Francisco. A last section entitled "Conclusion : Linkage and Fiscal Responsibility for Growth" states the results of the critical analysis.

CHAPTER ONE : THEORY AND EVOLUTION OF LINKAGE

A central theme of this investigation is that linkage can be viewed as part of a historical trend, a shift in public perception, from an era when growth and development were seen as unalloyed goods, to the present time in which growth is recognized as having social impacts requiring mitigation. Linkage, using economic modelling for its justification, has become a new way of conceiving and justifying funding for social programming through zoning law. Linkage programs focused on office development as the “identified troublemaker,” when growth led to the problem of rising land prices. The nexus between office development and rising prices has occurred in part because of the way the policy of linkage has developed historically, and in part because of how the concept has been defined in policy literature.

A Literary Definition of Linkage

Linkage has been defined in a variety of ways. The definitions, while at variance with one another about the extent of linkage and its public or private nature, yet contain some common elements. Linkage is seen as a political response to existing conditions, as a public attempt to grapple with issues of social services, as a mitigation strategy, and as a form of exaction. Keating defines linkage as a planning policy to, “mitigate the negative effects of commercial development,” and require, “commercial developers either to provide targeted employment, facilities, or services or to pay “in

lieu" exaction fees as conditions for obtaining development permits and rezoning."² Michael Klein, in a recent planning thesis at MIT defines linkage as, "the application of impact mitigation theory to non-public pieces of the regional economy/infrastructure, notably housing."³ Arthur Nelson, editor of *Development Impact Fees* cites, "Linkage fees are a political response to a problem that cities may more properly address through general taxes (Lee, 1988)."⁴ Andrew and Merriam call linkage, "a variety of programs that require developers to contribute toward new affordable housing, employment opportunities, child care facilities, transit systems, and the like, in return for the city's permission to build new commercial developments."⁵

To simplify the discussion one can posit linkage, not as a social policy, but rather as a style of argument used to forge a connection between an effect and its imputed cause. Tangled up together in the definitions above are issues about legality of exactions, zoning practice versus taxation as a means of social redress, public responsibility for social conditions, and developers rights and obligations. Embedded within these definitions are the problems of how zoning deals with positive and negative externalities, and the difference historically between fiscal zoning and externalities zoning. Linkage in San Francisco contains threads of these issues,

²Dennis W.Keating,, "Linking Downtown Development to Broader Community Goals," *Journal of the American Planning Association* , (Spring , 1986), p. 133

³Michael Klein, "Real Estate Development Exactions, Linkage, and the Nollan Decision," Master of City Planning Thesis, MIT, (1990) p. 14

⁴ Arthur Nelson, "Downtown Office Development and Linkage Fees," *Journal of the American Planning Association* ,(Spring , 1988), p.197

⁵C. I. Andrew, and D.H Merriam, "Defensible Linkage," *Journal of the American Planning Association*, (Spring , 1988), p. 200

intertwined into one policy. Linkage can be seen as a concept and a process; the creation of *arguments* with which planners can link issues together conceptually, legally and economically. Before redefining linkage it is necessary to untangle these threads, and look at each from a historical and political perspective.

Historical Background of Linkage

Evolution of Public Responsibility Issues

In early America, growth was seen as the paramount goal of the nation. Public support was codified in such measures as the 1841 *Act to Appropriate the Proceeds of the Sales of the Public Lands, and to Grant Pre-emption Rights* (5 Stat. 453). This act stated that,

“the net proceeds of the sale of said lands shall be faithfully applied to objects of internal improvements... namely: Roads, railways, bridges, canals and improvements of watercourses, and draining of swamps...”⁶

The notion that the public realm should provide infrastructure and improvements necessary for growth and commerce is thus an old one in our society.

Prior to the depression of the 1930's it was customary for municipalities to provide, and pay for, such items as new sewer lines or water main lines brought onto a development site.⁷ It was commonly held

⁶ From Haar and Wolf. *Land-Use Planning: A Casebook on the Use, Misuse, and Re-use of Urban Land. Fourth Edition*, (Boston, Little Brown and Company, 1989), p.

⁷Michael Klein, p

that growth in the tax base would repay the city's expenditures.⁸ Streets in subdivisions were often not built by the developer, but were paid for by the residents or the city, and title did not pass to the city until it had made the actual improvements.⁹ Thus public responsibility was viewed as the provision of infrastructure and amenities for the safety, health and welfare of its citizens, through zoning that promoted the preservation and enhancement of the public good.

On the other side of the issue, zoning law was established which delineated the boundaries of public control of private land use. These cases defined legitimate public control, and what constituted a taking of private property by the state. In *Euclid vs. Ambler*, it was established that, as long as the private owner was not denied a reasonable use of the property, the limitation of land use in the public interest would prevail over private plans for profit. This case also confirmed the state as the enabler and arbiter of zoning law, rather than the federal government. Thus the state's role in protecting the public interest lay in promoting the public health, safety and welfare through a delineation which limited conflicting uses, and through delineation of land use for approved development.¹⁰

During the depression of the 1930's, revenue-poor cities ceased providing free services and infrastructure, and the concept of private responsibility for not only infrastructure but social costs emerged. The first exactions were fees imposed on developers for infrastructure built or required by the city. The fees were assessments for direct costs, but it soon became common to assess fees for attributable indirect costs (such as the

⁸Haar and Wolf. p. 602

⁹Michael Klein, p 12

¹⁰See *Village of Euclid vs. Ambler Realty Co.* 272 U.S. 365 (1926)

necessity to expand a sewage plant). These changes coincided with the changing political belief that growth was not an unallayed good to be pursued. It became clear to municipalities that development was costly. The idea that city development costs would be repaid in tax revenues was replaced with the realization that development could occur so quickly that it could change the character of a town virtually overnight, and that the services required could bankrupt city coffers. In 1938, the New Jersey Court stated,

“We are surrounded by the problems of planless growth. The baneful consequences of haphazard development are everywhere apparent. There are evils affecting the health, safety and prosperity of our citizens that are well-nigh insurmountable because of the prohibitive corrective cost.”¹¹

During the 1950's, concerns over the cost of new development caused some cities to attempt to prohibit development. This was blocked legally.¹² The efforts of towns were thus directed toward changing the rate at which development could take place, and charging developers for costs incurred.¹³

The pendulum of public sentiment regarding responsibility for the effects of growth has thus swung from approval for pro-growth, city paid improvements to the opposite extreme. It is now widely believed that cities

¹¹ *Mansfield and Swett, Inc. v. Town of West Orange*, 120 N.J.L.145, 150, 151, 198 A. 225, 229 (1938), from *Haar and Wolf*. p. 600

¹² In 1954, the town of Milford, Connecticut tried to prohibit a subdivision, on the basis of its impact on schools, roads, and police and fire protection, because it would cause an “unbearable financial burden.”. In that case it was held that the planning commission did not have authority to deny approval. *Beach v. Planning and Zoning Commission of Milford*, 141 Conn. 79, 103 A.2d 814 (1954)

¹³ *Haar Wolf* , p. 602

are justified in making developers pay for as much as the local planning authorities are able to negotiate from them, in return for the privilege of project approvals. Developers, seen as money-laden fat-cats, are popularly portrayed as villains in film and television (see Spielberg's film "Batteries Not Included" for a striking example), and public sentiment overwhelmingly favors growth controls.¹⁴ Cities have lost much of their outside funding sources because of federal and state budget problems.¹⁵ To cities, the concept embodied in linkage, of using an economic argument to charge property developers fees, is one of the few ways left to raise funds that is politically palatable. Cities are empowered to pursue these policies through the exercise of police power, and the codification of that power is embodied in the enabling background in which linkage operates -- zoning law.

The Relationship of Zoning and Exactions

Zoning is not a simple matter -- thousands of pages have already been written and still fail to encompass the subject. This paper will seek to define zoning as it relates to linkage, and show how it provides the context for linkage. The context of linkage can be seen as belonging to two

¹⁴ Elaine Lafferty, "Growth -- The cautious approach is politically popular," *California Journal* (October 1987)

¹⁵ As this article is being written, the state of California is experiencing a 14.3 billion dollar deficit, an amount larger than the entire gross national product of some small nations. Cities in California, of course, are unable to raise property taxes because of the limitation imposed by Proposition 13, a property tax rate cap which was passed as a public referendum in 1978.

categories: externalities zoning, and fiscal zoning. Externalities zoning, and fiscal zoning are both based on nuisance law. To borrow an example from the opinion in *Euclid v Ambler*, a nuisance is a pig in the parlor instead of the barnyard. We might extend the metaphor by saying that an externality is your *neighbor's* pig in *your* parlor, and that this is what a large portion of zoning law seeks to prevent.

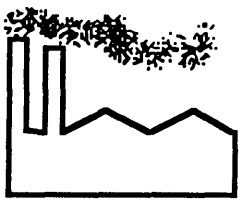
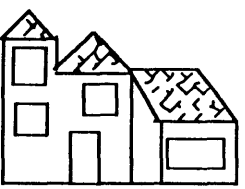
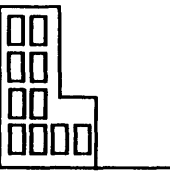
Externalities

In zoning, an externality is the effect that a land use at a particular site has upon its neighbors.¹⁶ These effects can be physical encroachments (such as pollution), sensory nuisances (auditory, visual, olfactory), social (a pornography shop next to an elementary school), or economic (a loss, or a gain in value to ones home due to adjacent use). Any effect, or externality, that has the power to change the health, safety and welfare of a community's residents is fair game for the type of regulation enabled through zoning law.¹⁷ As a property owner, there are externalities which can raise the market value of one's property -- positive -- as well as diminish it --negative (see Figure, Externalities -- Burdens and Benefits).

The nature of an externality -- whether one considers the effect of a development a benefit or a burden to individual property owners -- must be differentiated from its fiscal effect on the city. It is possible for a land use producing a negative externality, such as a factory producing smoke and noise, to result in a positive fiscal effect for the city because of taxes collected (See Figure, Externalities -- Burdens and Benefits). On the other hand a

¹⁶Michelle White. "Fiscal Zoning in Fragmented Metropolitan Areas," From *Fiscal Zoning and Land Use Controls*, Eds. Mills and Oates (H. Lexington, 1975)

¹⁷ See *Village of Euclid vs. Ambler Realty*

Land Use	Leads to Externalities	Fiscal Effect	City Policy
 Factory Built Near Residences	Negative Externalities (Burdens) Pollution Noise Traffic Aesthetic Change House Values Drop	City Collects More Tax \$\$ from Factory than Services Spent	Negative Externality (Burden) Controlled through Zoning Code - as in Euclid v. Ambler
 Neighbor Builds Wonderful Mansion	Positive Externalities (Benefits) Positive Aesthetic Change Large Lot Means: Less Pollution Less Traffic House Values Rise	City Collects More Tax \$\$ from Mansion than Services Spent	Positive Externality (Benefit) Encouraged by Lot Size Restrictions, Construction Codes -- See Mt. Laurel I & II
 Developer Builds Office Building	Positive Externalities Enhances CBD through Agglomeration House Values Rise Negative Externalities Traffic Congestion	City Collects More Tax \$\$ from Building than Services Spent BUT Must Spend More Tax \$\$ on Infrastructure	City Exacts Fees to Counter Burden but Interprets Benefits as Burden on Low-income Groups -- Assesses Fees for Linkage

Externalities -- Burdens and Benefits

positive externality may produce a negative fiscal effect. Consider the instance of a city which provides housing for low-income residents. Any externality which raises property values will raise rents for low income residents. The people who are barely meeting rents will then be forced onto public assistance. By causing them to seek public assistance, the externality, which is positive, will cause a negative fiscal effect for the city, as it finds itself paying more for services than it brings in from new uses. In other words, a positive externality of development such as rising house prices, which is a benefit to the individual homeowner, can become a fiscal burden for the city.

Externalities Zoning, Fiscal Zoning and Inclusionary Zoning

Externalities zoning is the body of zoning law which protects one land user from the externalities of another.¹⁸ It is zoning law which attempts to limit threats to the public safety health and welfare through separation of incompatible land uses. It is almost exclusively used to limit *negative* externalities, such as factories, or toxic waste dumps in residential neighborhoods. Externalities zoning thus seeks to limit the effects of poorly planned development through a careful distribution of the various uses found in a community.

Fiscal zoning is, “zoning motivated by fiscal rather than efficiency conditions.”¹⁹ Fiscal zoning, in its most neutral form, attempts to ensure that the local government will receive, from parties who incur a need for services, exactly the revenues required to offset the services it provides. In its most chauvinistic form, it can be used to make existing residents better

¹⁸Michelle White, p. 32

¹⁹Michelle White. *ibid.*

off at the expense of newcomers. Striking examples of this have occurred in the wealthy districts south of San Francisco. In Portola Valley, California, new subdividers have been required, through negotiation to install asphalt walking paths for hikers, and groomed horse trails through large tracts of open space dedicated from subdivision land by the developer. The residents of the cheaper subdivisions of the 1950's have no such encroachments through their backyards, but feel that such amenities keep the farmlike feel of the town intact. Needless to say, the town has avoided having an affordable housing policy, and the price of houses at the subdivision with the trails is between \$500,000 and \$1,000,000.²⁰

Michelle White in her article on fiscal zoning, has expressed the financial structure of fiscal zoning with the equation,

$$FST = tQ_A(P_L + E_A) - C_AQ_A - PCT * Q_A$$

where

FST = Fiscal Gain Expected

$tQ_A(P_L + E_A)$ = tax paid for newly developed property

$(P_L + E_A)$ = the price of land plus improvements

C_AQ_A = the cost of providing services to new development ,and

$PCT * Q_A$ = an environmental payment for the change induced by the new development (PCT is a pollution compensating transfer).²¹

According to Ms. White, the last term is one which reconciles the community to the change induced by the development. In economic jargon

²⁰ The author was a project manager for Hardesty and Associates, Landscape Architects, Menlo Park California and worked on several projects with these characteristics in the immediate area.

²¹Michelle White, pp. 38-39

one would say that this equation demonstrates the *internalization* of externalities, i.e. it makes the project pay for its external effects on its neighbors. Thus, if inducing indifference is the model, many terms could be added to this equation, including a linkage payment, in order to mitigate social impact.

Fiscal zoning to obtain a positive externality disallows development below a certain size, quality, and therefore monetary threshold. As in the example of Portola Valley, this has the effect of (and is sometimes created with the intent of) excluding people not able to pay the community's entry costs. Fiscal zoning most often results in a transfer of wealth through taxation. Exactions justified by the existence of externalities are sometimes a form of fiscal zoning, in that the exaction may make a newcomer pay for services or infrastructure which enhance the wealth of prior residents. Because of the present negative popular view of development and the politics attendant with that view, newcomers often have been forced to negotiate liberal agreements with a city to gain entry. The not-in-my-backyard syndrome assures that new developments will give more to the city than did the developments of the residents who preceded them. Such negotiations result in conditional agreements which have been approved by the courts.²² This isolation of newcomers as the undesirable messengers of the problems of growth, with its attendant demands that they mitigate as much of the costs as the city can recoup, is the political worm in the heart of the fiscal zoning apple. Linkage, as a form of exaction isolates the

²² As in *Ayres v. City Council of Los Angeles*, 34 Cal. 2d 31, 207 P.2d 1 (1949) in Haar, Wolf. See the section on legal evolution of exactions below.

newcomers, and provides a betterment to prior residents, and in this sense is a fiscal zoning policy.

Advocates of linkage would argue , however, that it redresses the ills caused by development, and that socio-economic concerns justify its nature as a fiscal zoning measure. The idea that socio-economic concerns can be redressed through changes in the zoning code, has been laid out in the arguments against exclusionary zoning. Two court cases, known as Mount Laurel I (1975) and Mount Laurel II established precedent against exclusionary zoning in favor of inclusionary zoning.²³ In Mount Laurel II the New Jersey court stated, “ inclusionary devices... are constitutional and within the zoning power of a municipality.”

And further,

“The very basis for the constitutional obligation underlying Mount Laurel is a belief, fundamental, that *excluding a class of citizens from housing on an economic basis (one that substantially corresponds to a socio-economic basis) distinctly disserves the general welfare...* It is nonsense to single out inclusionary zoning (providing a realistic opportunity for the construction of lower income housing) and label it “socio-economic” if that is meant to imply that other aspects of zoning are not.” (Italics mine)

This decision clearly states that exclusion of an economic class is sufficient need legally to impose a remedy (inclusionary zoning) based upon socio-economic arguments. The problem in Mount Laurel I and II was the desire of the city to adhere to a fiscal zoning policy in the face of the claims

²³ Mount laurel I is Southern Burlington County NAACP v. Township of Mount Laurel. 67 N.J. 151, 336 A.2d 713, appeal dismissed and cert. denied, 423 U.S. 808 (1975),.

Mount Laurel II is Southern Burlington County NAACP v. Township of Mount Laurel. 92 N.J. 158 A2d 390 (1983)

of less fortunate members of society excluded by these zoning practices. Put in terms of externalities, one could say that the town of Mount Laurel attempted to assure only positive externalities from development, to the detriment of the groups excluded by the policy, and that conversely social balance required the town to accept the possible negative effect of lower cost included housing. Social benefit in this case outweighed the individual benefit of members of the community whose property (they believed) would be affected by the inclusion of such housing. Inclusionary zoning was an attempt to remedy this problem. Inclusionary zoning is a policy which demands the inclusion of some proportion, in a market rate housing development, of housing units for low and moderate income people. Its justification rests upon the social argument found in Mount Laurel, and along with the rational nexus concept from exactions, the social argument for inclusionary zoning forms the basis for the validity of linkage.

Exactions, Externalities and Linkage

Linkage has evolved from exactions, as an explanation of the types of exaction will demonstrate. Exaction is defined in the Compact Edition of the Oxford English Dictionary as the “*action of demanding and enforcing payment (of fees, taxes, penalties).*” It is also interesting to note that in the next definition it is called an, “*exorbitant demand; extortion.*” Depending upon the developer with whom one discusses the issue, either definition may be used. Exactions may be considered as direct, and indirect. Indirect exactions are differentiated by the arguments used to justify them.

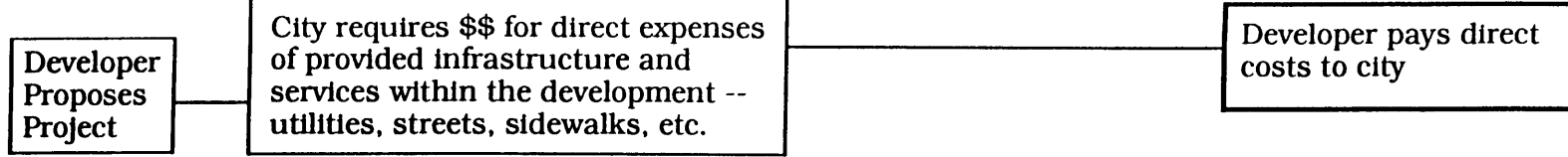
Direct exactions are akin to user fees. A direct exaction is a payment by the developer for on-site costs that a city must bear in order for a development to be built, such as water lines, sewer hook-ups etc. (See figure

“Evolution of Exactions to Linkage”) The city charges exactly what the necessary improvements cost. The costs are empirically measurable, that is, the city can measure the exact amount of work the development necessitated and render a bill for it.

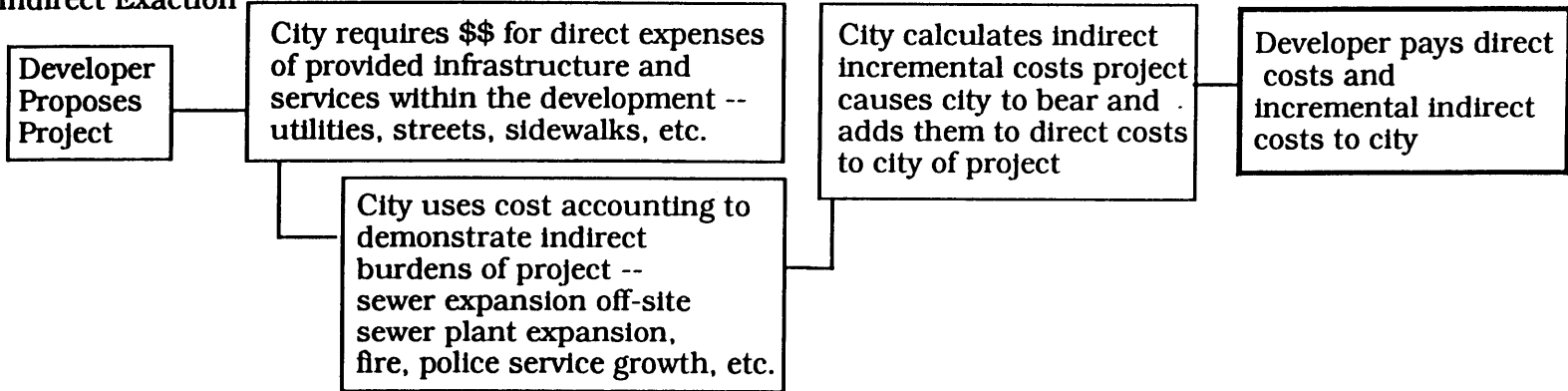
Indirect Exactions are fees for city costs indirectly related to a development (See figure “Evolution of Exactions to Linkage”). These costs are for infrastructure or services which the development causes a need for, but which are not on site, such as the expansion of a highway made necessary by an expected impact on city infrastructure. Indirect exactions also include payments for necessary increases in staffing or hours for fire, police and other human services provided by the city.

Indirect exactions are determined by cost accounting methods. Since the community, not just the development, will use off-site improvements and services, cost accounting determines a proportional share of the expected increases in city costs which are then apportioned to the development.

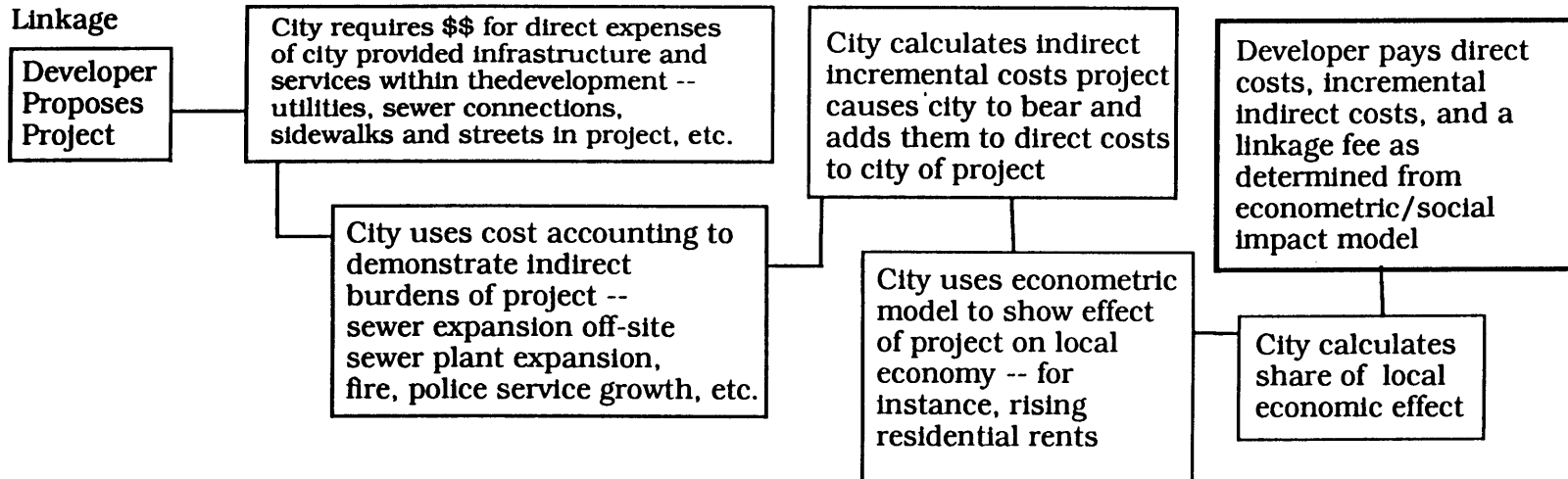
Direct Exaction



Indirect Exaction



Linkage



Legal Justification of Exactions and Linkage

“Rational nexus”, when used in the context of land use law is the concept that development exactions must have a reasonable connection to the impact caused by the development. In fact, rational nexus is the primary means by which communities have been able to shift what were formerly considered public costs onto private parties.

The roots of rational nexus of development and the costs of its impact are found in the Fifth (the necessity for due process) and Fourteenth (the doctrine of equal protection under the law) Amendments to the U.S. constitution, and in state enabling legislation giving municipalities police power to regulate land use. The cases for rational nexus tend to devolve on issues of procedural due process or substantive due process. Procedural due process specifies that processes shall be applied fairly. Substantive due process requires a municipality to act in a manner which is not capricious or arbitrary.²⁴ These requirements have been interpreted broadly and narrowly, by both courts and municipalities.

Rational nexus, allowing the use of municipal police power to levy exactions, has evolved from broad interpretations of social need, to strict assessment of costs uniquely attributable to a project, to social costs based on cost accounting formulae. A broad interpretation of the municipal exercise of police power is found in, in *Ayres v. City Council of Los Angeles* (1949). The city had demanded dedication of subdivision land for rights of way and planting strips on the road adjoining but not within the subdivision. The

²⁴This Argument is substantially taken from Andrew and Merriam, cited above.

developer wanted subdivision map approval without submitting to the conditions imposed by the city. The opinion stated,

“It appears to be the petitioner’s contention that no condition may be exacted which is not expressly provided for by the Subdivision Map Act...that at all events the requirements may deal only with streets to be laid out ...within the confines of the subdivision.”²⁵

The justices concluded about this petition that’

“It is no defense to the conditions imposed in a subdivision map proceeding that their fulfillment will incidentally also benefit the city as a whole.”²⁶

Thus exactions if “reasonably related” could be used to further the character and quality of improvement demanded by the city for “the protection of the public health, safety, and general welfare.”²⁷ Under this decision there was no requirement that the improvements be those which were specifically required for the creation or use of the subdivision.

As cases were tested in court, the police power to regulate land use through planning was extended. Justice William O. Douglas, upholding the power of eminent domain for slum clearance in his opinion on *Berman v. Parker* (1954) stated,

“Public safety, public health, morality, peace and quiet, law and order -- these are some of the more conspicuous examples of the traditional application of the police power to municipal affairs. Yet they merely illustrate the scope of the power and do not delimit it... the concept of the public welfare is broad and inclusive...The values it represents are spiritual as well as physical, aesthetic as well as monetary... a

²⁵ *Ayres v. City Council of Los Angeles* (1949) in Haar, Wolf, p. 624

²⁶ *Ayres v. City Council of Los Angeles* (1949) in Haar, Wolf, p. 627

²⁷ *Ayres v. City Council of Los Angeles* (1949) in Haar, Wolf, p. 625

community should be beautiful as well as healthy, spacious as well as clean, well-balanced as well as carefully controlled.”²⁸.

In contrast to the ideals of such decisions, stricter interpretations of rational nexus and exactions proposed more limited application of police power by considering exactions as akin to user fees. User fees were a typical exaction used by utility companies and adopted by towns.²⁹; In 1961 the Illinois Supreme Court validated only those subdivision exactions which were “specifically and uniquely attributable” to the subdivision.³⁰ This strict view of exactions was not universally taken up however. In an attempt to rationalize the problem of procedural and substantive due process in exactions Heyman and Gilhool in 1964, introduced the concept of determination of exactions by cost accounting.³¹ By the 1970’s, municipalities applied cost-accounting principles in assessing the expected direct and indirect public costs of a new development on the community, and sought to have developers pay the incremental or proportional costs produced by development.

Rational nexus as cost accounting has been refined through a number of court decisions. In Utah, the criteria for nexus expressed in *Banberry Development v. South Jordan City* (1981) included not only a

²⁸ *Berman v. Parker*, 348 U.S. 26 (1954)

²⁹ Nancy Stroud, “Legal Considerations of Development Impact Fees,” *Journal of the American Planning Association*. (Winter 1988)

³⁰ *Pioneer Trust and Savings Bank v. Village of Mount Prospect*, 176 N.E.2d 799 (Ill. 1961)

³¹ Heyman and Gilhool. . “The Constitutionality of Imposing Increased Community Costs on New Suburban Residents through Subdivision Exactions,” *Yale Law Review* (1964) According to Nancy Stroud, cited above, this approach was taken up quickly by the courts as a means of rationalizing the then rather chaotic manner in which exactions were calculated and assessed. *Jordan v. Village of Menomenee Falls*, 28 Wisc.2d 608, 137 N.W.2d 442 (1965), is an instance.

proportional formula for new improvements, but depreciated values for existing improvements.³² In Florida, a fair share formula charged developers for road expansion. The road improvements at issue were not associated with their development, but the money from the exaction fund was to be spent within a specified geographic area. This was upheld in the courts as having a rational nexus with three components: that the development does add traffic and therefore creates need, that the exaction is proportionate (i.e. that the development is not burdened with more than its fair share of needed public expenditures), and that the exaction reasonably benefits the payer, or user of the development.³³

The Utah and Florida views of rational nexus embody two slightly different versions of what is known as the free-rider justification for land development exactions. This idea states that if a benefit is public, there is no way to keep those who did not pay for it from using it. They are free riders - they get a benefit at the expense of those who paid. The problem in levying an exaction on development is that it makes newcomers pay for existing infrastructure, or makes them pay for new infrastructure, and unfairly enriches prior residents who become the free riders. In the Utah and Florida cases we see that proportional sharing of expense, and benefit to the project developer, are necessary procedural elements of legality to avoid the free rider problem, and the major substantive requirement for levying an exaction is that the municipality demonstrate need for the improvements or services.

³² Banberry Development Corporation v. South Jordan City, 631 P.2d 899 (Utah 1981)

³³ Home Builders and Contractors Association of Palm Beach v. Palm Beach County

The demonstration of need goes back to the issues enumerated by Justice Douglas in *Berman v. Parker*. Need, according to that decision, can be broadly interpreted to include community values that lie outside of the boundaries of cost accounting and benefit to the individual property owner. In *Mount Laurel I* and *II* need was defined using arguments of social utility based upon the fiscal dis-inclusion of lower classes, and this argument for need is the way that linkage ties together the legal use of rational nexus, the zoning considerations of public health, safety and welfare, and fiscal zoning policy.

Linkage -- The New Exaction

Linkage began as a political response to downtown growth -- it was first seen as a new form of indirect exaction levied on office development.³⁴ Linkage differs from direct and indirect exactions in that it does not seek to remedy on-site direct costs or empirically measurable indirect costs, but rather relies upon an economic model to establish a nexus. In the 1984 study which established linkage in San Francisco, Recht Hausrath and Associates proposed the first formula for imposing an exaction using an econometric argument to determine monetary impact, rather than a cost accounting approach.³⁵ Linkage uses econometric arguments to extract fees

³⁴ See the section of this paper on San Francisco and the Birth of Linkage

³⁵ The nexus argument for linkage by Recht Hausrath and Assoc., "The Economic Basis for an Office-Housing Production Program," (1984), was based on an econometric model of the effects of urban commercial development and was commissioned by the City of San Francisco. The same argument was published by Linda Hausrath in the *Journal of the American Planning*

or in kind services from developers. These exactions mitigate negative fiscal effects resulting from positive economic externalities related to development. The negative fiscal impact is a social need argument -- the problem of low income residents who pay more than a normal percentage of their income for rent, and therefore need more social services to make up the missing support. Under the social need argument for linkage a variety of programs other than housing have been included. In San Francisco these fees are used for affordable housing, child care, employment brokerage, public transit, open space, and public art.³⁶ In some cities fees are determined by negotiation,³⁷ and in others by a formula using the square footage or density of office space produced.³⁸

In some views, linkage is a form of inclusionary zoning, carried out as an exaction in order to yield housing or fees, rather than as a policy to produce higher tax revenues. Linkage, unlike inclusionary zoning, does not redress an imbalance created by zoning for positive externality, but rather seeks to redress a fiscal situation created by a positive externality. Linkage is dealing with exactly the same problem as Mount Laurel -- positive externalities excluding the poor from a community. It is notable that the effect being mitigated in both Mount Laurel and by linkage is an indirect effect and not the externality itself. The main difference between office

Association in Spring 1988 under the title, "Economic Basis for Linking Jobs and Housing in San Francisco"

³⁶ All of these are practices in San Francisco under the zoning code.

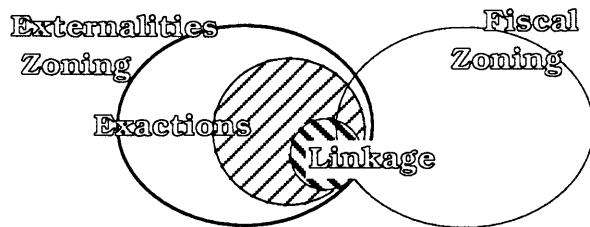
³⁷ Teresa R. Herrero, "Housing Linkage: Will it Play a Role in the 1990s?". *Journal of Urban Affairs*, vol. 13 (1991), pp. 1-19. Both Boston and Santa Monica negotiate linkage .

³⁸ San Francisco's linkage is a flat rate charged per building square foot., or as a per unit in lieu fee.

linkage and Mount Laurel is the source of the externality. But if the courts allow the externality in Mount Laurel as one which must be mitigated , and the socio-economic argument is sufficient, then linkage has the same basis of support as a type of fiscal zoning policy, and in towns where the externality for linkage exists there is an implied social responsibility to insure inclusion.

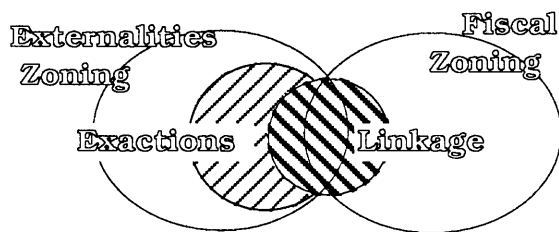
As in the Mount Laurel case, a legal definition of need can be determined using socio-economic goals. Linkage is justified by the same socio-economic goals, and the same relationship to a positive externality as was the case in Mount Laurel. If linkage has proportionality, and a clear benefit to the payer then it is the same as an exaction. Linkage may have a clear benefit to the payer if office developers can assure their tenants that housing will be available for the tenants employees. But since the housing provided is affordable, and may not be housing for use by people with downtown office incomes, the benefit is less clear -- more indirect.

Linkage specifically for affordable housing needs the sort of justifying argument found in the Mount Laurel decisions. In these decisions, a social policy (inclusionary zoning) was justified even though it did not necessarily produce an economic benefit to the payer; benefit to the payer was outweighed by considerations of fairness and benefit to the public. Linkage has evolved in practice into a form of exaction, which uses a rational econometric argument for its justification as an externality, but which uses a social justification of benefit lying within the province of fiscal inclusionary zoning programs.



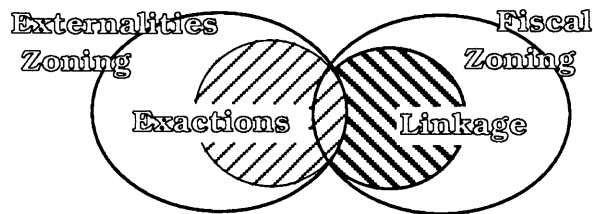
1981 - Linkage Begins

Linkage is a Category of Exaction



1984 - Recht Hausrath Study

Linkage Gains Econometric Nexus
Diverges from Exaction



1991

Linkage Arguments Used for Justifying
Fiscally Oriented Zoning and Exactions

**Relationship of Exactions to Linkage
1981 - 1991**

First English Church, Nollan, and Linkage

Linkage might have remained an isolated program, but two court decisions have recently called into question the conditions for governmental power to regulate and levy exactions. The effect of these decisions on regulation is far-reaching and unexpected.

In *First English Evangelical Lutheran Church of Glendale v. County of Los Angeles* (1987), the county passed an "interim flood protection" ordinance which prohibited the church from rebuilding a summer camp, Lutherglen, which had been destroyed by flood. The church went to court claiming that the regulation resulted in an uncompensated taking of their property, and they demanded just compensation. The California Supreme Court in a previous ruling had declared that a landowner may not maintain an inverse condemnation suit based upon a regulatory taking.³⁹ The U.S. Supreme Court ruled in *First English* that a temporary taking through inverse condemnation deserved compensation under the Just Compensation Clause of the Fifth Amendment.⁴⁰

In *Nollan v. California Coastal Commission* (1987) the issue involved the relation of stated social need to the land use conditions, or exactions, used to fulfill that need.⁴¹ The Nollans wished to revamp an old beach house. The California Coastal Commission, using its power to impose conditions on issuance of development permits, demanded that the Nollans provide a public access across their property between two nearby beaches. The condition was imposed on the basis of providing visual access

³⁹*Agins v. Tiburon* 24 Cal. 3d. at 275-277, 157 Cal. Reporter, at 376-378, 598 P.2d, at 29-31

⁴⁰ Inverse condemnation is the imposition of regulations which effectively prevent any allowed land use, and thus amount to a taking by the municipality.

⁴¹ *Nollan v. California Coastal Commission* 107 S. Ct. 3141 (1987)

to the beach. The Nollans' new beach house, however, did not impair the views from the two beaches, but rather from the street. In his opinion, Justice Scalia disallowed the imposed condition as having insufficient connection to the stated goal of the Coastal Commission in the case. The court made it clear that conditions placed on development must have a close nexus to the stated governmental purpose of the regulation or need enabling the imposition of conditions, or the conditions would be invalid, and would constitute an uncompensated taking.

These cases have made several issues clear to city governments. First, regulations may result in inverse condemnation or taking which requires just compensation. Second, if an exaction or policy is not supported by a rational nexus which is both substantively and procedurally supportive of due process, according to Nollan the policy may not be enforceable, and may also require compensation if pursued.. And even if the nexus does fulfill state goals, Judge Scalia's note on equal protection in the Nollan case implies that there must be a strict interpretation of proportionality, or a demonstration that no unequal burden is being placed upon one party to benefit the whole of society.⁴²

These seeming restrictions on public policy are a double edged sword. Cities are now forced to look into the legality of their policies. But while doing this, they may discover that by using the techniques of rational nexus with econometric and social arguments it is possible to justify linkage on a far broader array of issues than previously contemplated. The only bar to new linkage policies is acceptance in the political arena of the city in which they will take place. Any externality which can be econometrically

⁴² Nollan v. California Coastal Commission (1987)

determined, and causes a demonstrable social need can become a linkage item in the right politically motivated climate. And this, in fact, is happening in San Francisco.

CHAPTER THREE : HISTORY AND PRACTICE OF LINKAGE IN SAN FRANCISCO

San Francisco has always been a place for mavericks and has an unparalleled catalogue of eccentrics from Emperor Norton to the Sisters of Perpetual Indulgence.⁴³ In the political arena it has been a public policy trend setter since the early 1960's. Linkage in San Francisco sprang from the dynamic political scene which developed in the 1960's and continued through the 1980's when linkage was instituted. What happened in San Francisco at the institution of linkage was also a result of economic tumult of the late 1970's and 1980's , and after a short digression into the economic history to set the stage as it were, we will return to the political trends in San Francisco which paralleled the economic .

A Short Economic History

The commentary in planning journals on the issue of linkage rarely examines the economic context in which the linkage programs began and were carried out. In his 1985 study of developers and linkage, Keating concludes that linkage payments are of little concern to developers. In her 1991 paper, Teresa Herrero also gives a history of linkage as a vehicle for social reform, without noting the difference between the economic trends at

⁴³ Emperor Norton was a self-proclaimed ruler of the west in the 19th century who was held in esteem by the city of San Francisco, even though he was quite clearly crazy. The Sisters of Perpetual Indulgence are a group of male homosexual street performance artists who dress as nuns and dispense their perpetual indulgence on a grateful populace.

the beginning of linkage, and those existing after 1986.⁴⁴ As we know from hindsight, the conditions for cities and developers in the early eighties were quite different from the conditions existing now in 1991. In 1981 when San Francisco instituted its office-housing linkage guidelines a developers market was opening not due to the general economy, but because of changes in taxation pushed through congress by the Reagan administration. Inflation had dropped from the high rates of the Carter administration, and economic expectations for the 1980's were for continued growth. But the city of San Francisco was having budget problems in providing housing -- and that story began in 1978 with Proposition 13.

Taxes and the Real Estate Market

In California, a property tax revolt in 1978 resulted in voter approval of a ballot referendum on property tax limitation, which left cities scrambling for funds. Proposition 13 rolled taxes back to a reference year level, and stated that the tax for property owners would be no more than 1% of market value in the reference year. The reference year applied only to property presently owned. As soon as property changed hands the tax of one percent was charged at the new market value. In other words cities were no longer allowed to reassess property to adjust taxation except at sale. Fiscally this resulted in gross inequities of taxation, as two neighbors with similar property could be paying very different tax amounts, even though the rate was the same. In addition the initiative put tight restrictions on the ability of cities to assess new taxes. Cities thus began to look for other ways to increase revenues for social services. Linkage was one of these efforts.

⁴⁴ Teresa R. Herrero, pp. 1-19

In 1981, the Congress of the United States passed the Economic Recovery Tax Act. This act relaxed the at-risk provisions of the Internal Revenue Code, allowing investors to write off losses greater than the amount of their initial investment in a real estate project. These losses could then be applied to reduce the burden of taxation on income from other sources. The effect on real estate investment was nothing short of galvanizing. It was possible for the developer of a building to apportion negative cash flows to joint venture partners with high tax burdens, while keeping positive cash flows for investors who desired cash returns. This meant that virtually any building, no matter how much it seemed to be losing on paper would be a reasonable investment, because the deal was "tax-driven," i.e., there was enough money in the shelter as opposed to the actual cash flow produced by rents, that the real return to investors remained high.

The Tax Act of 1981 thus encouraged a climate of transactions which looked good on paper but which existed because of the vagaries of taxation, not because of sound business practice and conservative values. It was a chance for the very rich to enjoy a virtual cessation of tax liability while accumulating wealth. In this market, the addition of linkage fees to a deal made little or no difference in its perceived value to investors. If such fees caused marginal losses rather than gains, the losses could be apportioned to that part of the equity market which was looking for paper losses, such as doctors and lawyers.

The speculative tax-driven development caused by the Tax Act of 81 coincided with a relaxation of standards in the savings and loan industry, and with a rise in speculative investing by insurance companies and

institutional investors such as pension funds.⁴⁵ Huge sums were available to developers for investment in office buildings, and this pool of capital, combined with the effects of the tax act, produced an unprecedented construction boom in the office sector of the real estate market.⁴⁶

But in 1986 a new tax reform act was passed which eliminated the ability, for tax deductions, to use real estate losses to offset other income. Unfortunately for the U.S. market this, did not kill the speculative building of office space. Foreign investors came into the market, and because of their capital structure were able to buy buildings at low capitalization rates that inflated the market values and made continued speculative development profitable for a short time. As the overbuilding continued, vacancies rose and buildings failed to generate the income necessary to carry the debt imposed by low capitalization. This, and the lack of due diligence by the banks, resulted in a crisis in the market causing bankruptcy and eventually a drop in value for office properties. The real estate market collapsed, and with it the banks.

We are now in an era of retrenchment for banks and developers, whose assets are going into receivership. There is no capital for, or necessity for office development, and rents are now so low that many buildings have changed hands at losses which finally bring their capitalized value into balance with their income stream. It is against this background of financial irresponsibility of the 1980's that one must view the advent and use of linkage and the arguments for its justification.

⁴⁵ Lawrence Bacow, Speech at the World Trade Center, Amsterdam, Netherlands, 1991

⁴⁶ Lawrence Bacow, Speech at the World Trade Center, Amsterdam, Netherlands, 1991

Neighborhoods and Support for Affordable Housing

Decline of the Old Neighborhood Structure

In the neighborhoods of San Francisco, during the postwar period structural changes were occurring in the demographics and in the physical environment. Older blue collar families were leaving the city and being replaced with younger families and single people who were without the community ties to old political alliances. In some neighborhoods, the San Francisco Redevelopment agency removed entire blocks of housing occupied by the poor (for a variety of reasons including freeway development) and then failed to replace the lost units.⁴⁷ Curiously these changes were wrought in what were seen as less desirable neighborhoods -- notably minority neighborhoods, such as the Western Addition and the Fillmore district. When the freeways threatened to ram through more affluent or scenic areas, ruining views and property values, the public outcry halted the renewal programs.⁴⁸ These projects had been planned by the city, and gave rise in the neighborhoods to complaints that they were not represented well by the "downtown" interests.

⁴⁷ For a discussion of renewal displacement see Bernard Frieden and Lynn Sagalyn, *Downtown, Inc.*, (Cambridge, MIT Press, 1989), Chapter 2, "Sanitizing the City"

⁴⁸Public outcry stopped the freeways in San Francisco in 1959, and this action became the impetus for rebellion against renewal programs throughout the US. See Frieden and Sagalyn, *op. cit.* Chapter 3, p. 45. Public feelings still are volatile in San Francisco. In 1988 Haight-Ashbury activists lost a fight over permit approval of a Thrifty Drug store. The loss was felt so bitterly that an anonymous partisan lit the offending structure on fire. The developer, Thrifty Drug, subsequently pulled out of the project.

Neighborhood Empowerment

During the late 1960's and early 1970's San Francisco became the center of the phenomenon known as the counterculture, (including the flower-child era in the Haight-Ashbury district). San Francisco gay rights activists started the first gay and lesbian rights movement in the U.S. during this period, and the most prominent of these activists, Harvey Milk, was elected to office as a city supervisor. The black power movement, represented by the Black Panthers, the Black Muslims, and other groups less radical, grew in this period, and political organization efforts resulted in a political awakening of the minority communities in San Francisco.⁴⁹ This political ferment resulted in the formation of numerous neighborhood organizations, many of which still exist and wield some power today.⁵⁰

While the grass roots political organizations were forming in San Francisco, the physical and economic development of its downtown was proceeding, spurred first by Mayor Joseph Alioto, elected in 1968, and later continued by Mayor George Moscone and, after his tragic assassination in 1978, by Diane Feinstein his successor.⁵¹ Between 1975 and 1983 San

⁴⁹The Black Panthers were organized by Huey Newton in Oakland, California, just across the bay bridge from San Francisco.

⁵⁰ An example is HANC, the Haight-Ashbury Neighborhood Council, who represent a neighborhood group of largely radical, socially conscious members of diverse ethnic and sexual orientation. HANC runs a recycling center, and when the city wanted to cut down trees in Golden Gate Park, it was forced to deal with the neighborhood activists of HANC prior to working.

⁵¹ The death of George Moscone and Harvey Milk at the hand of Dan White a former supervisor marked a sea change in the political climate in San Francisco. The grass roots political movements which had formed and were slowly pushing old guard Italians and Irish out of city government coalesced around this brutal action which was seen by many as the old

Francisco added 18.1 million square feet of office space to its existing inventory.⁵² This was seen as a boon by the local chamber of commerce, but house prices and rents were rising, blue collar jobs were moving out of the city, and a new trend, gentrification, was squeezing low income people out of their communities.

Demographics, Income, and Willingness to Pay

During the period from 1970 to 1980 the demographics of income and rental patterns changed in San Francisco. While downtown grew, single households, non-family households and income per household grew as well.⁵³ While single households lowered the median income in San Francisco compared to the region, singles unencumbered by families were able to overpay (pay a greater percentage of income than normal) for rents. In 1980, 69% of renter households overpaid for rent.⁵⁴ Thus many households were able to bid high for the desirable locations, and drive up rents throughout the city.⁵⁵ There was also an influx of Asian immigrants who were able to afford the city by living at a higher density than was

guard's last attempt to stop the changes. For more on this, see the documentary film [The Life and Times of Harvey Milk](#) .

⁵² Nina Gruen, "A Case History of the San Francisco Office/Housing Linkage Program," in *Downtown Linkages*, Ed. Douglas Porter, Policy Education Forum, ULI (1985) p. 43

⁵³San Francisco Department of City Planning, *Residence Element of the San Francisco Master Plan, 1990*, Tables 5 and 19, and associated text.

⁵⁴ San Francisco Department of City Planning, *Residence Element of the San Francisco Master Plan, 1990*, Table 49.

⁵⁵ Kenneth Rosen and Ruth Shragowitz, Working Paper 85-94 Center for Real Estate and Urban Economics, University of California, Berkeley, (1985) p. 8, and San Francisco *Residence Element of the Master Plan*, p.13

acceptable to the ethnic groups which had preceded them.⁵⁶ These demands kept rents high; residential vacancy stayed in range of one percent in the early 1980's. The result was a rise in the cost of housing. In reaction, activists pushed through rent control laws and condominium and residential hotel conversion limitations, and created a referendum petition for affordable housing linkage.

Public Perceptions of Downtown and Policy Initiatives

The public perception of downtown development changed between 1960 and 1980, from a more-or-less positive acceptance of the virtues of increased commerce, to an aggressive stance against increased development in downtown San Francisco. In the early eighties as linkage was being tested and reviewed, developers were on a binge that made their supply of money appear to be an endless flowing fountain, but housing advocates were dealing with a different reality. There was a rising affordability gap in San Francisco, and viewing the (supposedly) fat profits available to developers, housing activists found an easy and politically expedient target on whom to focus. This opposition to development arose from the grass-roots political organizations advocating affordable housing which had formed in the neighborhoods, and from groups concerned with the "Manhattanization" of San Francisco's skyline by highrise development.⁵⁷

⁵⁶Asians lived at a median density of 3.2 per household compared to 1.8 for whites in 1980, according to the San Francisco *Residence Element of the Master Plan* (1990). The proportion of Asians in San Francisco now is greater than in 1980, so one may expect the effect to be exacerbated. See 1990 census tract data, San Francisco Department of City Planning, unpublished.

⁵⁷Nina Gruen, pp.43-44. Manhattanization was a term made popular by the columnist Herb Caen of the San Francisco Chronicle.

The Linkage Programs

The Birth of Linkage in San Francisco

In 1980 the group San Franciscans for Reasonable Growth (S.F.R.G.), believing that office development produced more cost than revenue to the city, collected signatures on a petition for a referendum measure to force a linkage between office development and the provision of affordable housing.⁵⁸ The petition required mitigation measures from developers for what were seen as the social costs created by continuing development. The city planning department, reacting to the political pressure of this petition, codified its substance, and in 1981 Mayor Diane Feinstein presented the result -- a policy document called "The San Francisco Office/Housing Production Program (OHPP) Interim Guidelines For Administering The Housing Requirements Placed On New Office Developments,"⁵⁹ OHPP was the first program of its kind in the U.S., and soon after its inception other municipalities followed suit.

The OHPP Interim Guidelines came at a time when people in San Francisco were realizing the impact of the economic changes of the Reagan era. Federal housing funding had been cut by the administration. As discussed previously, there were effective grass roots advocacy organizations which dealt with a variety of political issues in the city, including linkage, and the San Francisco planning department was as progressive in outlook

⁵⁸Susan Diamond, "The San Francisco Office/Housing Program: Social Policy Underwritten By Private Enterprise," *Harvard Environmental Law Review* Vol. 7:449, (1983), p. 451, note 8.

⁵⁹Diamond, *ibid.*

as the advocacy groups. Based on a 1979 study put together by local activists, the planning department formulated mitigation policies for the growth in downtown development which was believed to be changing land values throughout the city. The original argument for linkage was based on the political ideal of developer responsibility (discussed earlier). The first proposed nexus for these measures were the findings of environmental impact reports (EIRs) required under the the California Environmental Quality Act (CEQA).⁶⁰ CEQA mandated that all environmental effects of development must be eliminated or shown to be capable of mitigation. The strictures of the act were construed by SFRG to mean that the social effects of development were subject to mitigation by developers. This interpretation was over-ruled by the state, however, and San Francisco was forced to do its own study to determine the rationale for its linkage of office and affordable housing.⁶¹ This study, by Recht, Hausrath and Associates became the basis for the program finally passed as law in 1985 by the San Francisco Board of Supervisors, the Office-Affordable Housing Production Program (OAHPP).⁶²

OHPP and OAHPP

OHPP was a program to provide support for housing in San Francisco. It exacted housing from developers using a formula based on the expected number of new employees per building who would necessitate new residential space in San Francisco. This requirement amounted to 880 units per one million feet of built office space. The requirement could be

⁶⁰The OHPP Guideline Revisions issued by Dean Macris on January 22, 1982 quote EIRs as a source in the first line of the discussion of the background of the interim guidelines.

⁶¹Keating, (1986) p. 138

⁶²Recht Hausrath and Assoc., *The Economic Basis for an Office-Housing Production Program*. July 19,1984

met in different ways. The developer could build new housing or renovate existing housing. The developer was also allowed to fulfill this requirement by investment in others' housing projects in order to supply the requisite number of units. And lastly, a developer could participate in the city's mortgage bond revenue program by giving in-lieu fees instead of housing units.

Surprisingly, given its political genesis, OHPP had *no requirement* that the housing provided be affordable housing. This was unclear even to political activists at San Francisco Information Clearinghouse who wrote ,

“the intent and charge of the OHPP is quite clear. Downtown office and highrise developers must:

1. Produce new and affordable housing.”⁶³

Neither of the claims listed in this quote are true. Developers were allowed to build market rate housing, and they were allowed to renovate old housing. And many units completed to satisfy OHPP requirements were market rate.⁶⁴

OHPP *did* have a complicated credit system which offered incentives to developers for producing affordable housing, but the program itself simply demanded units. The argument for OHPP stated in the first sentence of its description, “Findings from EIRs show that the construction of new office buildings create a demand for housing in excess of the supply provided by the current market.” The only requirement was to provide

⁶³ San Francisco Information Clearinghouse, *A Critique of San Francisco's Office Housing Production Program With Recommendations For Corrective Action*, Undated, p.1

⁶⁴ Mayor's Office of Housing, *Annual Evaluation of the Office/Affordable Housing Production Program* (December 1990), p. 6

enough housing for employees in the buildings such that, should they want to rent in San Francisco there would be units available. The exaction for housing, precisely because it did not demand affordability, was a direct mitigation for the presence of the new white collar employees.

To take up the argument begun previously in the section on the theory of linkage, it was argued there that if linkage has proportionality, and a clear benefit to the payer then it is the same as an exaction. In the case of the OHPP guidelines, the benefit to the payer, the office developer, was the ability to assure tenants the necessary services (housing) for their operation in San Francisco. The proportionality is established through a formula in the guidelines, and while the numbers may be arguable the concept is nonetheless clear. Since OHPP provided a clear benefit and since it provided proportionality, and since the social need was clear, OHPP fulfilled the requirements of rational nexus proposed in the Palm Beach case mentioned earlier. If OHPP had specified affordable housing the benefit to the payer would have been legally tenuous. OHPP fits well within the category of an exaction justified by rational nexus precisely because it does not specifically mandate affordable housing.

OHPP was criticized by activists for several shortcomings. They wanted OHPP separated from the control of the planning department, and they wanted OHPP to have a legal status separate from the regulating ability of the planning office. They complained that,

“Program operations are characterized by a closed and arbitrary “deal” negotiation process and those housing plans having final approval are marked by inequities.”⁶⁵

⁶⁵ San Francisco Information Clearinghouse, *A Critique of San Francisco's Office Housing Production Program With Recommendations For Corrective Action*, Undated, p.2

They demanded elimination of “deals” and elimination of the complicated credit system of affordable housing incentives. They also demanded that a set contribution per unit be charged to standardize the developer contribution.⁶⁶ The criticisms of OHPP and the necessity for a formalization of the process resulted in the 1985 enactment of the Office/Affordable Housing Production Program (OAHPP). Of OAHPP the San Francisco Information Clearinghouse wrote:

“The passage of the OAHPP capped a seven year advocacy effort by community groups and non-profit development corporations to halt or at least minimize the rampant gentrification of affordable housing and the displacement of thousands of low income residents which directly results from the massive development of commercial office highrises... the OAHPP was politically imposed upon the city government which at every turn delayed the process and sought to introduce exemptions favoring office developers or weakening lower income affordable housing production mandates.”⁶⁷

The previous mandated housing requirement of 880 units per million square feet was reduced in OAHPP to 386 units per million square feet.

In the report for San Francisco which put forth the economic nexus for linkage, Linda L. Hausrath elevated the housing demand argument used in the OHPP guidelines to an economic argument, but combined it with a cost accounting argument (to determine the number of office workers to be housed, and the correct number of units per square foot of building needed) which in concept was essentially the same as the OHPP formula. The economic argument was based on the following chain of causality: that

⁶⁶ San Francisco Information Clearinghouse, *op. cit.*, p.5

⁶⁷ San Francisco Information Clearinghouse, *San Francisco's Office Affordable Housing Program*. October 1985. p.1

office development accommodates employment growth; employment growth equates to growth of labor employed; increased labor employed implies increased population; increased population yields increased housing demand; increased demand results in increased housing prices.⁶⁸ There are arguable assumptions in each link of this argument, but it was sufficient to allow OAHPP code enactment.⁶⁹

OAHPP differed from OHPP in that it eliminated the complex credits system of OHPP and shifted the focus from market rate with affordable housing incentives to affordable housing only. There is a significant difference between the arguments for OHPP and OAHPP. At its root the nexus for OAHPP posited the existence of a positive externality that was credited with a negative social impact. It did not try to fulfill the need for housing the employees in the office buildings by demanding the sort of market rate housing office workers might be expected to desire, but moved one step further to affordable housing only. In this step to affordable housing, the San Francisco linkage program ceased to be an indirect exaction and moved into the arena of fiscal zoning for social support.

Linkage As a Social Services Provider

While the city was preparing its new OAHPP ordinance, the planning department was also preparing a new set of office-linkage fees. These included social services that the city felt related to office employment. After the passage of the OAHPP code in 1985, the city of San Francisco legislated linkage for childcare services and brokerage, employment

⁶⁸Recht Hausrath. p. 1-2

⁶⁹San Francisco Zoning Code Section 313 Housing Requirements for Office Developments (Added by Ord. 358-85, App. 7/19/85)

brokerage, open space, parks, transportation, transportation management, and public art. These programs rely for their justification entirely on the established linkage program arguments. Without the ability to impute an indirect social effect these linkage fees could not be justified. And the argument for indirect social effect cannot be made with an exaction argument only -- there must be an economic argument which validates the chain of reasoning. Thus with its social legislation the city moved further into the realm of fiscal social zoning arguments, but as with housing linkage, using the form of an exaction rational nexus argument based on economic modelling rather than on cost accounting. The fact that the city pursued these social programs indicates the willingness to apply the linkage format to a wider range of issues than has been done elsewhere.

Linkage and the Effect of Growth Limitation

Public pressure regarding development took several forms in San Francisco. Multiple initiatives to limit downtown development were launched. Between 1971 and 1986 there were 5 initiatives, only the last of which, Proposition M, was passed into law by the electorate in 1986. Proposition M limited downtown growth to less than a half million square feet of office or commercial space per year. The limitation was governed by what has come to be called "the beauty contest," section 322 of the planning code which delineates a developer competition for building rights. Exemptions were to be allowed only by voter approval in a general election.

The immediate effect of the passage of Prop. M was that it created, according to one developer, " a spike in supply -- developers pulled their permits. Tenants expected rent increases, so they relocated even before the

increases appeared.”⁷⁰ The less immediate effect is that the proposition has worked as envisioned. New office development slowed, from 6,958,683 square feet under construction in 1985 to just 1,836,210 in 1989.⁷¹ “Now it isn’t possible to justify development because rents have declined and bank problems prevent financing.”⁷² It is interesting that a growth initiative passed the same year as the Tax Reform Act of 1986, as both would work in concert to diminish drastically the funding provided through linkage.

Trends in the Future Provision of Linkage and the Services it Funds

Linkage in San Francisco is empowered through the zoning code, and it is part of the zoning permit process for development rights under the zoning code. Officially there is no negotiation over linkage fees or credits for housing. In practice however there is some negotiation emerging from the way that developers attempt to satisfy the planning commission. This negotiation is a process, not between the official linkage programs and the developer, but between the developer, the public (in the form of neighbors, neighborhood organizations, and advocacy groups) and whatever housing producer, child care provider, or employment brokerage or transit management program the developer uses to fulfill linkage requirements.

If the future follows the trends of the last decade, the trend of linkage in San Francisco will be toward more socio-economic fiscal zoning regulation justified through a rational nexus of econometric arguments. Linkage style arguments will probably be used because of Nollan and First

⁷⁰ Personal Interview, June 1991

⁷¹ San Francisco Department of City Planning, “Downtown Plan Monitoring Report 1985-1989,” (January, 1991) pp. 53-54

⁷² Personal Interview, May, 1991

English. The necessity for affordable housing will grow, because San Francisco is a constrained market and will therefore continue to experience competitive bidding for housing, which will continue to drive up prices. But as office development grinds to a halt, funding of linkage for affordable housing and services will almost certainly have to come from segments of the economy other than the office market.

This brings up the question of whether or not linkage has a chilling effect on the real estate market. The evidence in San Francisco is so confused and tangled that there is no way to tell reliably what effect linkage has had. There are just too many causes for the same effect. Downtown building has declined, but it would have stalled due to the overall market conditions in any case. And in San Francisco the growth limitations prevent any meaningful attempt at proving causes for slow development. Anecdotal evidence from developers is, however, clear. In conversations with project managers and senior executives of development companies with major office buildings in San Francisco, all said that linkage did not change their desire to do business in San Francisco. Opinions of the policies themselves varied. But at the Gerald Hines Company, the presence of linkage was commented on this way,

“Linkage runs about 15% of our hard costs(Construction costs before paying fees, interest, development salaries, etc.). We have ongoing social service obligations of child care, transportation management, and employment brokerage. We are taking a good faith attitude -- we’re looking at it as providing a tenant service that can provide less congestion, more spending in the city, and higher productivity at work. When we add linkage fees in as a capital cost they only come to one or two percent.”⁷³

⁷³ Personal Interview, May, 1991

With no downtown development it is hard to envision where money for affordable housing will come from. Political activism by neighborhood groups provides one avenue. In Bernal Heights a retail paint chain who wanted to develop retail space was forced by the neighborhood to stack affordable units over the storefront.⁷⁴ But another possibility for funding of services exists through the mayor's office of housing which runs OAHPP. Since OAHPP is primarily a funds assessor and distributor, it is part of a ready made network to distribute any kind of funding. Currently OAHPP is being used to leverage matching grants from the federal government. Thus while linkage itself may become a minor funding source, the agencies and networks set up to deal with the flows of funding will still continue to be useful, which in turn assures the long-term existence of the linkage programs through the real estate cycle.

Negotiated Development and Density Bonuses, and Inclusionary Zoning

San Francisco now has negotiated density bonus programs which lie somewhere between linkage and inclusionary zoning.. According to the implications about equal protection in Nollan by Justice Scalia, there are problems with negotiated development conditions, because they may not reflect procedural due process under the 14th amendment of the constitution.

It has been suggested in articles by Herrero, Keating, and Goetz and others, that a way of making linkage work is to grant a quid pro quo of

⁷⁴ Information from personal interview, May 1991. The chain was Standard Brands Paint, and the neighborhood group was the Bernal Heights Neighborhood Association. The units are attractive neo-victorian units, in contrast to the usual warehouse-style buildings inhabited by the chain..

density bonuses. Because they may involve negotiation, such density bonus programs may not be legal under Nollan. They also make no sense in the current economic climate. There is no need for more office space now -- adding a density bonus is like offering a person in a leaky boat a hole saw instead of a bucket to bail with. Adding density programs for housing can also be problematic due to differences in the cost of construction as density rises.⁷⁵

There are elements of the city planning department who would prefer negotiation, but this is looked upon as legally dubious by those who prefer a strict and easily verifiable set of linkage fees.⁷⁶ Because of Nollan, all sides of this regulatory argument are scared that the police power to demand exactions will be diminished.

Inclusionary zoning is allied to the density bonus problem. The density bonus programs were an attempt to institute inclusionary zoning which followed the lead of the California state law (which does empower the ideal of inclusionary zoning with a density bonus quid-pro-quo).⁷⁷

⁷⁵Personal Interview, May, 1991. According to Tom Jones of the Mayor's Office of Housing, high rise buildings have problems of market acceptance. Four stories is a traditional height in San Francisco and that style of building is the preferred San Francisco look. Buildings over four floors jump in cost due to the need for parking and elevator requirements. The city subsidized highrises, Fillmore Towers and South Beach are in danger of bankruptcy due to lack of demand. Meanwhile the low rise developments, 2001 Post, and Bayside Village, which are at the same density per acre as the highrises, are doing extremely well. This points up a practical difficulty with inclusionary housing zoning density bonuses as a strategy in San Francisco.

⁷⁶Personal Interview (May,1991)

⁷⁷California Governmental Code Section 65915 enables density bonuses for affordable and elderly housing of at least 25% for a 25% dedication of units as low income for 50 years,, but allows an unspecified bonus for a contribution of 10% of the units as low income.

What San Francisco is aiming at now is different. The formulators of a new inclusionary zoning policy would like for it to be based upon a linkage style rational econometric argument so that they are not obliged to give, or negotiate, any quid-pro-quos.

Set-asides

Set-asides are programs in which land is set aside by a developer for a purpose determined by a city, and has been used in the past for the creation of landscaping and parks. San Francisco is now considering the rezoning of tracts of underutilized industrial land to residential use, and then demanding set-asides for affordable housing. In this way developers would benefit, the city would add to its scarce supply of land for housing, and residents would benefit from the increase in affordable housing stock. To avoid the appearance of spot zoning the city must demonstrate a rational nexus for the inclusionary requirement. That nexus will likely be the sort of fiscal zoning-social need argument that has been evolved in linkage.

Non-Profit Development Corporations and CDC's

Non-profit developers are becoming the primary affordable housing producers in San Francisco. Community Development Corporations (CDCs), incorporated neighborhood organizations providing housing, are a quasi-public subsector of the non-profit housing market funded through community block grants, as well as through other funding including OAHPP money. Office developers seek out these organizations to help them fulfill their linkage requirements, and CDCs go to developers with new projects with proposals to help with the housing requirement. In this way linkage through past funding has helped produce a housing production network to serve the city. Now that these organizations are up and running

they can utilize funding from any source, so that if linkage changes and adds programs, these housing providers will be the beneficiaries of those funds.

The San Francisco Redevelopment Agency -- No Linkage, No Land

The San Francisco Redevelopment Agency, much like the Boston Redevelopment Authority, works as a public partner with private developers to provide projects for the economic improvement of the city. In its capacity as a development partner it uses forms of inclusionary zoning, mortgage Revenue Bonds, in lieu fees, deal equity and upside participation. These powers make the Redevelopment Agency unique in the city, but unlike its counterpart in Boston, it cannot and does not negotiate for, or take part in, the official linkage program in any way.

The separation of the Redevelopment Agency and the linkage programs came about through the political history of the two institutions. Redevelopment was started by downtown interests after World War II.⁷⁸ As the linkage movement in San Francisco came from groups opposed to the aims of redevelopment and downtown interests, the two programs were institutionally separated.

With the appointment by Mayor Art Agnos of Buck Bagot, a staunch affordable housing advocate, as president of the Redevelopment Agency, the tenor of redevelopment in San Francisco changed. As Buck Bagot put it to me, "I don't care if another market rate unit is ever built in San Francisco." The Redevelopment Agency now cuts deals with its partners, and these deals are often more advantageous for the city than the linkage program. As a current in lieu fee for affordable housing, the agency is asking for 50-60% of unit value from developers, or approximately \$50,000

⁷⁸ See a discussion of redevelopment by Frieden and Sagalyn, *op.cit.*

to \$70,000 per unit. This is a great deal more than the current \$18,808.29 required in 1991 by the linkage program. And they are able to request, and receive from commercial developers a proportion of refinancing proceeds from projects in which they are partners.⁷⁹ In addition, Redevelopment Agency negotiations are not based upon rational nexus, but rather upon the nature of the deals it makes with its private development partners. As part of its deals however, the agency's private partners, who are sometimes non-profit foundations, are allowed to accept linkage funding from other developers who need to make good on their linkage commitments. Thus through a daisy chain of commitments developers with linkage obligations may find themselves negotiating their linkage with the Redevelopment Agency.

With their relative power and bargaining ability one might wonder why all housing is not done by the Redevelopment Agency on Agency controlled land. The answer is simple. Unlike New York's Public Development Corporation, which has a constant inflow of abandoned parcels deeded to it by the city of New York, the Redevelopment Agency is running out of land with which to deal. There are only several major parcels left in agency control. San Francisco as a whole is virtually out of land to develop, and when the land is gone, the Redevelopment Agency will cease to have a base from which to operate. Public-private

⁷⁹ Personal Interview, May, 1991. The example related to me by the president of the redevelopment commission was that of the new Marriott hotel in downtown San Francisco. Marriott refinanced the hotel some four years after building completion, and the Redevelopment Agency at that time asked Marriott for part of the upside proceeds. This was unexpected by Marriott, but they were still under an obligation with the city that would have made it politically and legally difficult to refuse, so they negotiated with the agency.

development by the city as a partner is not likely to continue much longer or have a very great effect. Thus for San Francisco, some form of housing linkage and its allied programs will likely become even more vital to affordable housing production than in the past.

CHAPTER THREE : A CRITICAL REVIEW OF LINKAGE

Implicit Assumptions of Linkage

The original argument for linkage of office development to social betterments relies on several assumptions. A political climate exists in which office development is considered not as a general social good, with associated costs that society is willing to pay, but as a burden to society which produces profits for a few and costs for the many.⁸⁰ In this view, regional economic development, demographics, and changing mix of employment from industrial to white collar and service, are not seen as the driving force of change in the marketplace, and office developers are not simply responding to a perceived demand. Instead the issue of change in the community is focused on the single issue of office development as a driver of social change.

The second assumption in the argument for linkage is that the impact of center development on house prices is an externality of office development which requires *mitigation* by the office developer, because the developer is producing the impact, and profiting. In San Francisco this arises out of a political imperative imposed by the community groups such as SFRG in reaction to what is seen as a housing crisis. The basis for this mitigation concept can be found in the political climate from which the concept of rational nexus has unfolded (outlined in the previous section

⁸⁰ San Francisco Information Clearinghouse, *A Critique of San Francisco's Office Housing Production Program With Recommendations For Corrective Action*, Undated, p.2

“Political Background of Linkage,” and “Zoning and Exactions”), and in San Francisco in the political perceptions of the advocacy groups (discussed in the sections on OHPP and OAHPP).

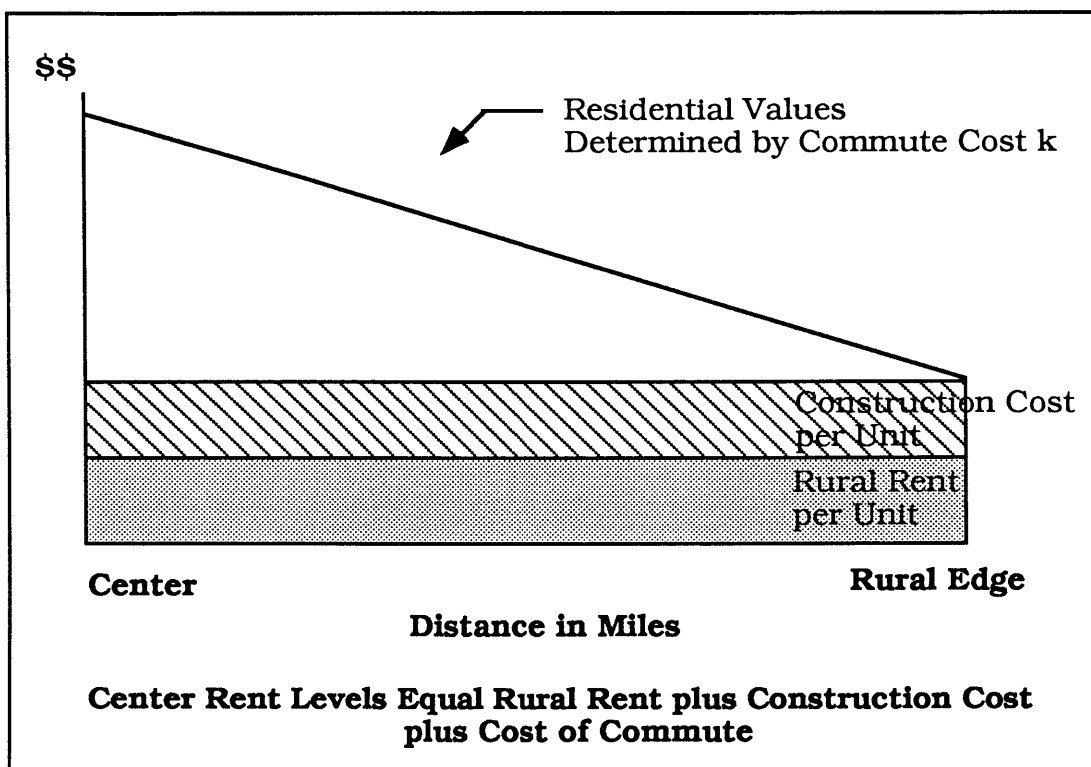
The third assumption made by linkage advocates is that linkage is a quantifying of economic externalities. This has been disputed in a recent article by John Henning, Jr.⁸¹ Henning’s argument states that linkage is a wealth transfer based on a pricing change, rather than a mitigation of economic externalities, and that it should, therefore, be a tax rather than a payment by an individual entity. This argument leads to issues of equity and the political nature of the imposition of linkage. It emphasizes the idea that consumer demand which drives up pricing is not a sufficient reason to impose mitigation through linkage, and suggests that linkage is untenable legally. This paper has argued however that linkage as practiced has evolved into more than an exaction mitigating an externality, and has not yet addressed the issue of equity or political distribution of money or benefits created by development. To consider these issues I shall posit an economic model of house pricing and growth , and using this model evaluate linkage as an argument, and as an effective political policy.

Center City Land Pricing Model, Housing Cost, and Density

In an economic model of regional urban land pricing, the cost of housing is dependent on the size of the urban center, and the commute

⁸¹ John.Henning, Jr. “Mitigating Price Effects With a Housing Linkage Fee”. *California Law Review*. V. 78 N.3 (May, 1990).

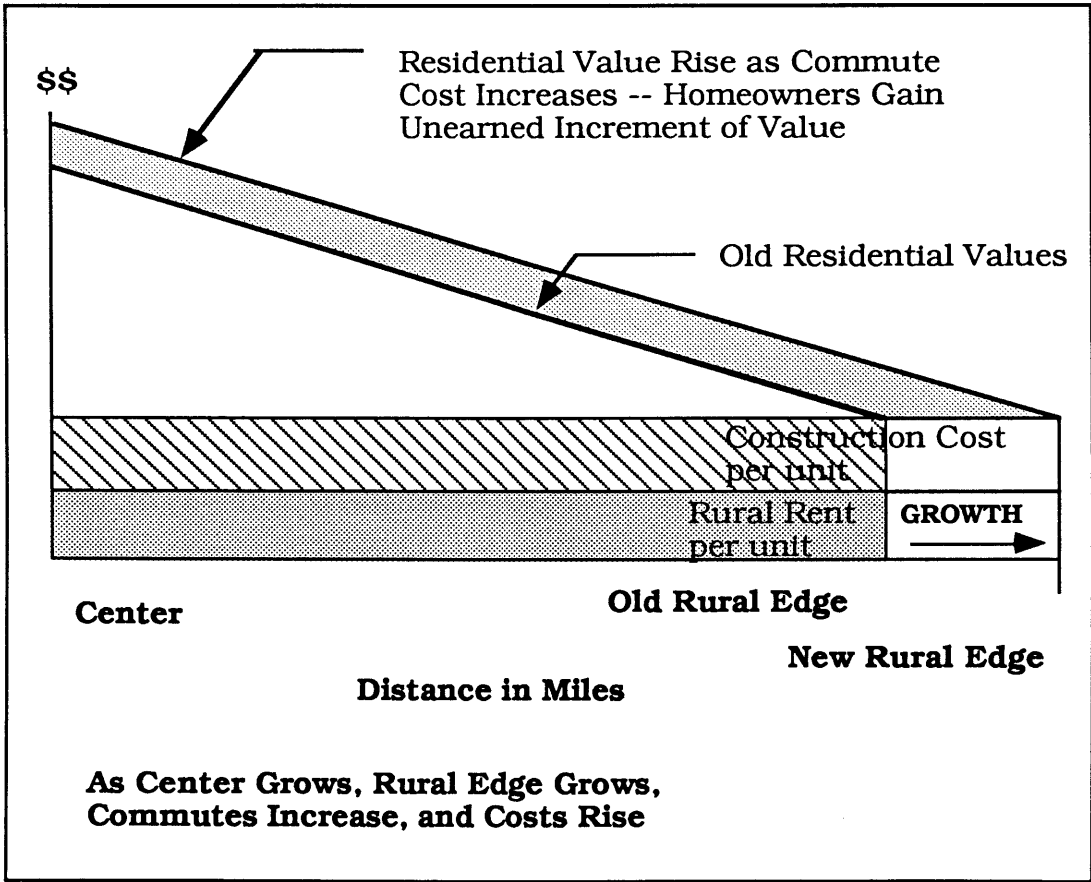
necessary to reach the center.⁸² The idea in this simple model is that people work at the center, that each household occupies the same amount of raw land (i.e. land use density, or floor area ratio is constant), and that each household is paid the same amount for the same work.



Given that this is the case, those who live near the center will spend less money on commuting and will therefore be able to pay more in rent, while those on the fringes will have a more aggravating and costly commute but will pay less per square foot for their land rent. This is a model in which everyone has the same indifference to conditions -- more rent is always balanced by less commuting, more commuting is always balanced by lower rent (See Center Rents Diagram).

⁸²This economic model is taken from personal notes on a series of lectures by Professor William Wheaton of MIT

Thus rents at the urban edge will be equal to agricultural rents plus construction cost, while rents at the center will be equal to the rural rents plus construction cost plus the added cost of the commute that is not made. In other words, the base cost in any region is the rural rent plus construction cost, and the rents rise for locations near the center -- the people who live closer can afford to pay more because they don't pay for the commute.



The foregoing clearly indicates that as the size of a center grows (i.e. as more people are employed) the area required to house them will expand, and commute costs will rise. As commute costs rise the rural rents will remain the same, but the offsetting value of the long commute avoided by

those in the center will raise rents in the center by an amount corresponding to the commute cost increase.

Density and Willingness to Pay

But in the real world some people make more money than others, some are willing to outbid others for desired amenities, and land costs more at the center than at the edge. Land prices for any one site are a function of willingness to pay (the amount people are willing to bid for any particular item or service), construction cost and allowable density of development. Land prices in equilibrium are equal to land profit. They are the residual, over and above construction cost, which is yielded by the willingness to pay at a particular density or floor-area ratio (FAR).

In theory, people should be willing to pay more to live or work near an amenity, i.e. the desirability of a location should determine its rent or sale price. The willingness to pay more for a better location is offset by the density of development, so that as density (or FAR) increases in any one location the willingness to pay decreases. As FAR increases, construction costs go up, and willingness to pay goes down. Thus at some point profit per unit of land will drop. This means that there will be an optimum FAR at which the willingness to pay per unit of space at a particular construction cost for space yields the highest profit per unit of land developed. If we can find the willingness to pay is for a location, and if we know construction costs and their relation to FAR, using a standard unit for comparison, we can determine the FAR which will yield the maximum profit for land.⁸³

⁸³ In a theoretical model that is delineated by Professor William Wheaton of MIT, willingness to pay minus construction cost is equal to profit per housing unit, and profit per unit

Thus we can see that pricing of land will vary by the zoning, the ability of people to bid for it, the desirability of amenity provided, the density allowed, and the construction or replacement cost of structures placed on the land. This model also shows that there is an optimum density for any site which is based on consumer willingness to pay, and this willingness to pay will set land pricing. Everywhere that FARs are held lower than this market land price would demand, the housing expense will rise due to the under-utilization of the land with respect to the market.

Looking at the housing market from this point of view, personal preference has as much to do with the cost of housing as does downtown development. What one would expect from such a model is that housing costs for a particular site in San Francisco would be governed by allowable density, and by the ability of homeowners to find acceptable housing elsewhere at a lower cost. From the macro or regional viewpoint one would expect the rents to be high in San Francisco, and to fall toward the urban edge. In fact, this is the case in the San Francisco region. House prices are higher in Orinda (closer to San Francisco) than Walnut Creek (down the road about 30 miles), and higher in Walnut Creek than in Antioch or Pittsburgh (at the outer edge, 50 miles).

of land is equal to profit per unit of building times allowed density or FAR. This can be expressed as:

$$\begin{aligned}
 &\text{if,} && \text{WTP/square foot of floor area} = a - b\text{FAR} , \\
 &\text{and if,} && \text{Cost/square foot of floor area} = c + d\text{FAR} \\
 &\text{then,} && \text{Profit/square foot of land} = (\text{WTP}-\text{Cost})\text{FAR} , \\
 &\text{or,} && \text{Land Profit} = \text{FAR}[(a-c)-(b+d)\text{FAR}] = (a-c)\text{FAR} - (b+d)\text{FAR}^2
 \end{aligned}$$

One can then take the derivative of this last permutation of the equation and the result is the optimum FAR, based on willingness to pay, which yields the highest land profit per square foot.

These models also imply that there is an advantage for businesses to decentralize. By going where people are living at lower cost, businesses can capture the value of lower commute and housing costs, and thus lower their own costs through lower wages. This too has happened. Of the 57,000,000 million square feet of office space in the bay area, only 46% is now in San Francisco, while Pacific Telesis, Chevron, and other major corporations have established offices in the suburbs.⁸⁴

There is therefore, a chicken and egg problem in the San Francisco argument for linkage that appears under scrutiny. The bay area has expanded to over six million people, and it is as easy to argue that development occurred because of the popularity and the willingness to pay which yields profit, as it is to claim that the popularity of San Francisco and willingness to pay resulted from development of downtown offices. In truth, the processes do not seem sequential but are bound inextricably. Developers must pay prices based on values set by the market, and are as much at the mercy of these conditions as individual homeowners and renters. A look at home prices and office development over the last five years in San Francisco is revealing. Office development has been constrained, and since 1985 has dropped from around seven million square feet under construction to around two million feet under construction in 1989.⁸⁵ As the proportion of such development in San Francisco has been dropping, house prices have risen dramatically. From 1980 to 1985 the

⁸⁴Kenneth Rosen and Susan Jordan, "San Francisco Real Estate Market: The City, the Peninsula, and the East Bay," Center for Real Estate Economics, University of California Berkeley, (1988), pp. 35-40.

⁸⁵San Francisco Department of City Planning, *Downtown Monitoring Report 1985-1989*, January 1991

period previous to the growth limitation and decline of office development house prices moved from a mean of around \$130,000 to around \$170,000, an increase of 30.8%. From 1985 to 1989, house prices moved up to around \$320,000, an increase of 266%.⁸⁶ The increase in housing prices was on an accelerating trend that seems to warrant a more cogent explanation than office construction.

What is an alternate explanation of the bay area's phenomenal rise in value? If one considers a typical supply growth caused by immigration of labor, wages go down as rents rise (see figure). During the last 25 years people have flooded into California from all over the U.S. and from other countries as well, raising demand for housing but encouraging lower real wages because of job and housing competition. In other words immigration helps to produce the gap between affordability and house pricing.

In response to this immigration, a number of municipalities have introduced zoning controls which raise the price of entry into their communities by demanding minimum lot sizes and a high quality of construction and landscaping.⁸⁷ In San Francisco, the zoning code has lowered FARs in the neighborhoods at the request of local residents while raising FARs on high use corridors and in certain districts.⁸⁸ Unfortunately, the cost of building changes at certain thresholds increases so greatly in relation to willingness to pay, that in San Francisco it is very difficult to

⁸⁶San Francisco Department of City Planning, *Residence Element of the Master Plan, 1990*, Graph 9, Housing Price Trends

⁸⁷See the zoning codes for Palo Alto, Woodside, Menlo Park, Portola Valley, Los Altos, Los Altos Hills, etc.

⁸⁸ San Francisco Department of City Planning, *San Francisco Master Plan Land Use Index*, Undated

successfully develop high rise residential development.⁸⁹ Since land prices remain high, these constraints help to lock these neighborhoods into expensive pricing.

The theory for nexus we started with, that as the center grows rents will rise, does not imply causation. The center and the region grow for a number of reasons, and there is no logical way to prove more than a connection between area size, prices at the center and a gradient to the edge of the next subcenter. Given that the entire region's growth is responsible for rising prices, and given that communities are allowed to practice minimum lot size zoning, the provision of affordable housing should be a regional responsibility, and there is ample causal relationship and legal precedent to encourage such a view.

The argument for San Francisco's linkage policy, based as it is upon demand for residences produced by the office workers of a particular building, may fall into the trap referred to by John Henning. Henning argues that office workers are simply outbidding previous residents, and that the price rise is therefore a market effect of individual price decisions which does not bear mitigating. If the reason land prices escalated had to do with a few office workers then this analysis would be correct, and the city of San Francisco would do well to rethink the nature of their justification. If land prices were responding, as I have argued, to growth trends which encompass not only office workers but the entire growth of the city center, then there is ample argument for linkage. The question becomes, why is the policy restricted to such a small group, when all zoning categories participate in the growth which fuels escalating prices?

⁸⁹ See note 73 above.

CONCLUSION : LINKAGE AND FISCAL RESPONSIBILITY FOR GROWTH

Given that linkage is a means of mitigating the negative social effects of positive economic externalities, the way that linkage is applied is inconsistent and much of the value created by externalities is being lost by municipalities. Linkage was generated by political impetus, against the wishes of city officials, and targeted to one outstanding group who became the identified troublemakers on whom to fix blame. Like Willy Sutton the bank robber, they went where the money was kept. For this reason, linkage currently focuses on one part of the equation, and attributes causality to downtown development. One might ask, however, why private landowners around the central business district should reap windfall profits, while developers are forced to pay mitigation for the profit-taking done by these landowners. After all, if the homeowners, in recognition of the public interest, were restricted to a reasonable profit level over their original purchase price, the problem of affordability would not exist, and house prices in San Francisco would not have risen by 266%. The problem is that in markets such as San Francisco, homeowners can reap large profits on the sale of their homes, and thus people are willing to pay higher than normal prices based on expectation of appreciation. Therefore, private homeowners are taking advantage, through speculative buying and selling, of the very affordability problem which activists complain is being generated by office construction.

Office linkage can be rationalized to make it equitable. If office linkage was pursued using an econometric model showing optimum FAR

(and therefore highest land profit), balancing optimum FAR against the windfall produced by regional growth, it would be possible to show quantitatively what benefit the city was conferring through development rights, what density would be optimum for the site, and how much of the profit is unearned windfall the developer should return to the city. And it would assure the developer of a reasonable profit -- and developers, unlike homeowners, have shown themselves to be amenable to even the most stringent regulation if it allows them a reasonable way to make profit.⁹⁰

The wider application of linkage to capture the benefit of a positive externality as experienced by all who profit from it, is extremely unlikely. Proposition 13, the property tax initiative, has allowed homeowners in San Francisco to profit without paying tax for that profit. Homeowners in California have reaped outrageous rates of return on their dwellings, and yet they do not feel politically responsible for the cost of home ownership, and the tax revolt illustrates that any attempt by the state to recapture the incremental wealth produced by the housing market will be looked upon as an assault.

This discussion points up the necessity for re-evaluation of the public view of regional economic processes. There are many problems implicit in growth, and property tax limitation with linkage fees as band-aid solutions should be the subject of intense debate. If taxes are allowed to escalate with the market, pensioned elderly and fixed income residents suffer. If taxes are held artificially low, then municipalities who are subject to inflationary costs in provision of services will suffer.

⁹⁰ This form of analysis would also help the city to avoid the building of office projects in areas where the demand for them is marginal, and where the land could best be put to some other use.

One way to solve this dilemma would be the use of a transfer tax on sale of real estate that captured windfall profits resulting from growth and rising values. The nexus between the lack of affordable housing and profit taking by homeowners is the same as that between downtown development and housing pricing, and some form of transfer fee should be relatively easy to quantify using a land profit model of pricing, and could be easily justified using a linkage style argument. A formula for capture of positive externality for homeowners would include a measure of the proportion of their profit based on the externality of center growth. For instance if the house price is discounted for inflation, and if it can be determined that some percentage of the price difference occurred because of downtown growth as opposed to other factors, then that amount attributable to downtown growth would be taken as a linkage fee for affordable housing, because it would represent the homeowner's windfall profit at the expense of less fortunate members of society.

Linkage will continue, but it needs to be evaluated as a device. Cities must come to terms with the more general issue of the public obligation to mitigate the problems caused by society at large. The magnitude of effort necessary to overcome the affordability gap far outstrips the ability of office linkage to supply funding. And by focusing too narrowly, linkage helps cool public debate on these issues. Linkage gives the appearance of activity, and meanwhile the structural economic issues are swept under the political carpet.

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