Case Study
Public Incentives for Low-Income Housing

Public and private interests may come together to promote multiple objectives by allowing denser development in a suburban setting. Re-zoning land for denser development can offer great opportunities for developers. Requiring the new developments to serve social purposes, such as housing for families with low-income, may be the grounds for a public-private partnership (PPP).

Suppose that a developer is interested in constructing apartment houses in a suburban town where zoning currently allows only single-family housing on 1-acre lots. The developer has plans for constructing three buildings with 10 apartments each on a 5-acre site. The expected cost per unit is $150,000 and the developer plans to lease the units for $2,500/month. Operating expenses are expected to be $500/month per unit. The annual net income is therefore:

Annual net income = 10 units ($2,000 /month/unit) (12 months/year)

= $240,000 per year

Since the ten-unit building is expected to cost $1.5 million to construct, the expected ROI is expected to be $240,000/$1.5 million, or 16%. The developer's MARR is 12%, so this is a very attractive proposition. However, unless the zoning is changed, the 5-acre site will only be able to be used for five single-family houses. Without the zoning change, the developer would have to sell the recently acquired site and seek development rights elsewhere.

The town is interested in creating housing that will be suitable for low- and middle-income families. They thought that it might be possible for the town to build low-income housing, which would be made available to town employees at a maximum rent of $1000 per month. They found that the construction costs for a 5-unit building would be $160,000 per unit, with monthly operating costs of $600 per unit. The net rent per month would therefore be just $400. The town could sell bonds with an interest rate of 4%, so that the annual interest cost per unit would be 4% ($160,000) = $6,400. The net rent of $400 per month or $4,800 per year would be insufficient to cover these interest payments. If the town went this route, they would have to include an additional $6,400 - $4,800 = $1,600 per unit in the town's budget, which they would prefer not to do. The town therefore approached the developer about the possibility of allocating some of the units in the proposed apartments to low-income residents whose rent would be set at $1,000 per month.

The first question is whether or not there is some basis for a partnership. To answer this, we need to determine the maximum reduction in rent that the developer could accept while still earning an acceptable return on the project. With an MARR of 12%, the developer needs an annual return of $180,000 (12% of the $1.5 million investment), which is $60,000 less than the expected rent of $240,000 per year. Reducing the rent from the market rate of $2,500 per month to the desired rate of $1,000 per month would cause a loss of revenue of $1,500/month or $18,000/year for each unit. Thus, even if the developer had to make three units available to town employees at the lower rent, he would still have an acceptable MARR:

ROI with 3 low-income units = ($240,000 – 3 x $18,000)/$1.5 million = 12.4%

If the developed is forced to decide between abandoning the project and accepting a project in which three units are reserved for low-income families paying lower rents, then the developer would likely accept the deal. Of course, the developer would be likely to say "if you provide a subsidy of $1,500 per month per unit ($18,000 per year), you could rent as many as you like."

The town would probably consider $1,600 per year as the maximum subsidy that they would consider, as they could build their own complex if they were willing to provide that level of subsidy. Thus they would be unwilling to provide anything close to the desired subsidy.

On the other hand, they could perhaps offer something else. Suppose the state had approved legislation aimed at promoting the development of low-income housing by allowing the state to guarantee the interest on loans associated with constructing housing in which at least 25% of the units were reserved for qualifying low-income families. Under this legislation, the interest rate on the developer's loans would drop by 2% if the development qualified. If the developer had a loan of $1.5 million, a 2% reduction in the interest rate would be worth more than $30,000 per year. This would be equivalent to $10,000 per unit if three units were reserved for low-income families.

Is this enough to close the deal? Maybe and maybe not. It depends upon how badly the developer wants to proceed and how aggressive the town is willing to be in considering the re-zoning application. It is conceivable that some residents in the town will prefer not to attract low-income families – and it is conceivable that others will be very supportive of initiatives that allow young families and public employees to live in the town. Another step that could be taken would be to allow the developer to add a couple of more units to each building, thereby making the overall development more attractive.

Resource: Project Evaluation: Essays and Case Studies
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