

## The Unassailable Case against Affordable Housing Mandates

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Current disquiet about the shape of housing markets in the United States has brought forth systematic proposals for their reform. Some of these move in a pro-market direction. These include removing zoning restrictions on new construction in order to increase supply. They also include direct public subsidies for specific classes of housing paid from general public revenues, such as Section 8 Housing, which offers rental housing assistance to private landlords on behalf of low-income tenants (Housing Act of 1937, 42 U.S.C. § 1437f). As between these two, I prefer the market liberalization because only it can produce the double benefit of lower administrative costs and the expansion of supply. In contrast, direct public subsidies require higher taxes of unknown incidence and severity that generate political controversy and deadweight social losses. This chapter, however, bypasses both these programs to exclusively critique affordable housing mandates for “inclusionary zoning.” These mandates have gained in popularity in recent years, precisely because they do not require any direct appropriation of public funds. In June 2015, a unanimous California Supreme Court, speaking through Chief Justice Tani Cantil-Sakauye in *California Building Industry Association v. City of San Jose* (61 Cal. 4th. 435 (2015)) (CBIA), rebuffed constitutional challenges to the San Jose affordable housing program that “requires all new residential development projects of 20 or more units to sell at least 15 percent of the for-sale units at a price that is affordable to low-or moderate-income households” (CBIA at 442). Those programs are now operative in more than 170 municipalities in California alone (CBIA at 441).

Inclusionary zoning is defended as a way to combat:

within the urban and rural areas of the state a serious shortage of decent, safe, and sanitary housing which persons and families of low or moderate income . . . can afford. This situation creates an absolute present and future shortage of supply in relation to demand . . . and also creates inflation in the cost of housing, by reason of its scarcity, which tends to decrease the relative affordability of the state’s housing supply for all its residents. (Cal. Health and Safety Code section 5003, subdivision (a))

The statutory finding, however, does not explain why competitive markets are in permanent disequilibrium. Nonetheless, the California Supreme Court upheld the statute against a takings challenge that treated this mandate as an unconstitutional exaction against developers, without explaining how the inclusionary zoning mandate could achieve its intended result. More recently, New York City in March 2016 adopted an aggressive affordable housing mandate that requires the developers of new housing to include, on a negotiated basis, two tiers of affordable housing: one for low-income persons earning between 40 percent and 80 percent of the median income, and a second for people earning about 115 percent of the median income. Only developers who comply with both mandates will receive the benefit of rezonings offering them either greater height or density. The combined number of units under both programs constitutes about 20 percent of the total units in any project.

In this chapter, I will examine these programs through both an economic and legal perspective. In so doing, note the vivid contrast between bundled cross-subsidies on the one hand, and explicit cash subsidies on the other. The difference is that conditional permits keep these expenditures off the balance sheet, and thus further away from political scrutiny and public deliberation. If these programs are desirable, let the state rent or purchase the units at market value, and then re-let or resell them at below-market prices. As the late Justice Scalia wrote in *Pennell v. City of San Jose* (458 U.S. 1 (1988)):

The traditional manner in which American government has met the problem of those who cannot pay reasonable prices for privately sold necessities – a problem caused by the society at large – has been the distribution to such persons of funds raised from the public at large through taxes, either in cash (welfare payments) or in goods (public housing, publicly subsidized housing, and food stamps). Unless we are to abandon the guiding principle of the Takings Clause that “public burdens . . . should be borne by the public as a whole,” *Armstrong [v. United States]*, 364 U.S. 40, 49 (1960),] this is the only manner that our Constitution permits.

Ignoring this principle leads to a broad set of unfortunate consequences. In order to explain why, I shall proceed as follows. Part 3.1 addresses the means-ends question of whether these programs are capable of achieving their stated goals, or whether, as seems likely, they exacerbate the current housing shortages, given that any restriction on new entry into housing markets should both constrict supply and raise prices at all rent levels. But in these cases, it would be a mistake to concentrate attention solely on the particulars of a program, given its interaction with other housing market regulations. Thus, in New York City, it seems likely that its strict rent stabilization law will further reduce effective supply, putting greater stress on affordable housing programs to make up the slack. The combination of higher costs and lower benefits can hardly be expected to improve the overall situation in housing markets.

Once the economic analysis is complete, I shall turn to the constitutional question of whether the effort to force the costs of new housing onto the developers of future housing projects violates the Takings Clause by imposing an unconstitutional condition on new real estate development. That position is widely rejected today on grounds articulated in *CBIA*, which are that the doctrine of unconstitutional exactions only applies in those cases where the government attaches conditions on the physical occupation and use of land, as in *Nollan v. South Carolina Coastal Council* (483 U.S. 825 (1987)), in which the state demanded that a homeowner yield a lateral easement to the public across his beachfront property in order to obtain a building permit to build a new and large house on his property; or in *Dolan v. City of Tigard* (512 U.S. 374 (1994)), which involved a bike path over and a flowage easement across the Dolan parking lot. The requirement that some undesignated fraction of units be reserved for low- and middle-class affordable housing was held not to burden the occupation of land in *CBIA*, and thus did not qualify as a per se taking under the rule in *Loretto v. Teleprompter* (458 U.S. 419 (1982)). Accordingly, the court upheld its constitutionality under the far-lower standard of rational basis review articulated in *Penn Central Transportation Co. v. City of New York* (438 U.S. 104 (1978)), which sustained New York City's landmark preservation ordinance. But this classification is incorrect even under existing law. Without question, the *Loretto* rule applies when the state directs a private owner to allow a private person to occupy a specific property. In principle, it continues to apply even when the property owner is allowed to decide which unit will be so assigned to an eligible tenant against his will.

### 3.1 THE ECONOMICS OF AFFORDABLE HOUSING PROGRAMS

The initial inquiry for inclusionary zoning asks why the law of supply and demand fails in an unregulated housing market. One claim is that such housing is impacted by "public actions involving highways, public facilities, and urban renewal projects" (Cal. Health and Safety Code section 5003, subdivision (a)). Two replies should be decisive. First, these commonplace actions have not stopped housing markets from clearing in thousands of settings that do not involve inclusionary zoning. Second, to the extent that intrusive urban renewal projects do distort housing markets, the first-best solution is to curtail those innovations, not to heap a second imperfection atop the first. Less, rather than more, state intervention is required.

Nonetheless, California moves sharply in the opposite direction by creating a complex regime of positive rights in which "the provision of a decent home and a suitable living environment for every American family," is said, without proof, to depend on inclusionary zoning to create a strong state economy with low levels of unemployment (Cal. Health and Safety Code section 5001). That system is most definitely not one "in which the housing consumer may effectively choose within the free marketplace" (Cal. Health and Safety Code section 5001). Recall that in normal market settings, supply and demand tend to come into equilibrium through

entry and exit. Shortages induce new entry until anticipated rates of return are reduced to a risk-adjusted competitive level. Conversely, market gluts lead the least efficient suppliers to exit until the market is once again in equilibrium. To be sure, entry and exit are never costless, even in an unregulated economy, so we can always expect some deviations from optimal housing levels. But these problems are only aggravated by stringent zoning and excessive permitting restrictions that hamper both entry and exit – who can leave if there is no clear place to go? In contrast, open markets allow individual players to rely on their specialized knowledge to decide on entry and exit strategies. The presence of queues in price-regulated markets, as happens with inclusionary housing, is an unmistakable sign of market disequilibrium. Affordable housing is in fact a form of rent control that always creates systematic shortages.

To see the exit point, note that one reason why developers will commit to new construction of housing is if they know that they (or their buyers) can switch their end uses if the original plan does not work. This one insight condemns statutes like the San Francisco Residential Hotel Unit Conversion and Demolition (Ordinance (S. F. Admin. Code) ch. 41), which requires that any property owner who wants to replace long-term resident units with short-term units in a tourist hotel must either supply substitute units of similar housing, or pay an “in lieu” fee to the City in order to construct new units of low- and moderate-income housing. In sustaining the ordinance, the California Supreme Court stressed that the legislation reverted to a rational basis to argue that the City had wide latitude in choice of means to address the perceived shortage of affordable housing within the City, especially for its most vulnerable populations (*San Remo Hotel v. San Francisco City & Cty*, 41 P.3d 87 (2002)).

The Court acknowledged that the San Francisco ordinance recognized both tourism and housing were essential to the welfare of the City, but then missed the central point. The Court did not explain how any planning agency could know which use is more valuable in what location, which owners do best. In addition, the Court in *San Remo* thought, incorrectly, that displaced residents had some vested right to secure substitute housing within the City. That analysis misfires on two grounds. First, it requires double benefits from a single move, for in addition to the benefit of the new operations coming in, it becomes critical to supply workable substitutes for the displaced operations elsewhere. Why burden unregulated transactions that produce net social benefit? Second, these communities might easily supply residential facilities even if their locational disadvantages make it virtually impossible to supply short-term rental space for the tourist trade. Needless to say, *San Remo* did not exhibit a glimmer of recognition that restraints on exit rights will necessarily reduce the willingness of developers to engage in new construction.

A similar logic applies to the inclusionary zoning programs that the California Supreme Court blessed in *CBIA*. But how these increase housing supply for the most vulnerable populations is left unclear. On the supply side, any affordable

housing mandate necessarily increases the administrative costs of running every aspect of the development process. For starters, inclusionary zoning proposals say nothing about required quality standards for the various private units and the public spaces. In practice, it is difficult to find the right level of amenities that meet the budget and preferences for individuals with gross disparities in income levels and personal tastes. To close that gap, developers traditionally catered each project to individuals who shared the same taste in public amenities, which cannot be done under inclusionary zoning.

A similar dilemma arises in designing the individual units. To build units of equally low quality will guarantee a sharp decline in the rents for the market-rate units. To use high-class materials, appliances, and finishes for the affordable units would increase the loss per unit. Thus it is necessary to figure out three different classes of appliances, finishes, and designs, for low-, middle-, and market-rate units, thereby raising costs for all units. Costs further increase when regulations require that the different types of units be evenly dispersed throughout the larger structure. Different brokerage teams, marketing strategies, and credit reviews are needed for the three different types of units, driving up staff size and costs. Qualifying particular applicants for the low- and middle-income units is a constant headache, given annual fluctuations in family composition and income. Higher-income or -net worth individuals cannot be allowed to gobble up the subsidies targeted to lower-income people. But determining annual eligibility is costly and error ridden when current tenants and future applicants change jobs from time to time, often work off the books, or fraudulently conceal income sources. None of these external standards applies to market leases, where tenants are always free to spend less on housing than they can afford. Yet what property owner wants to force out tenants who become better risks when their incomes improve? Much-needed public audits drive costs still higher.

The situation looks no better from the demand side. This entire edifice rests on the vagaries of non-quantified cross subsidies. The basic conceit is that the ability to charge high rents on the market-rate units will offset the mandated losses on the low- and moderate-rate units, thus allowing the developers to secure a reasonable rate of return on the overall investment. But new entrants offer a far better way to constrain developer returns at all market levels. In contrast, this regulatory system is fraught with risk that tenant resistance in the market-rate units not offset the losses in regulated units, thus pushing any comprehensive project into negative territory. The off-book accounting means that increasing the fraction of affordable units magnifies a future risk, which is subject to changes in future regulations. No regulator has any a priori way to determine the level of the net profits needed from the market-rate units or the prospects of their realization. Traditional rate making for public utilities knew of this risk and required a reasonable rate of return on each separate project for each annual period.<sup>1</sup>

The situation is made even more difficult because unit values are not just a function of their location, size, and quality, but also of their immediate neighborhoods. A *New York Times* story by Nelson Schwartz (2016), ominously titled “In an Age of Privilege, Not Everyone Is in the Same Boat,”<sup>2</sup> attacked the Norwegian Line for outfitting its luxury cruise ships with a safe “Haven” reserved for premium passengers who wanted superior accommodations and priority access to common facilities. The separation improved matters for both groups, by increasing total revenues available to cover common costs (e.g., the engine room) without driving away customers in either service tier. Opportunity for gains arises in all forms of housing. A luxury building with large and small units can work if both groups want the same kind of public amenities, but it will fail if one group wants doormen and the other does not. It is just these pressures that drive residential developers to target discrete groups, not the whole population. They internalize all the soft externalities and thus tend to get the optimal mix of tenants along multiple dimensions that outsiders find difficult to identify.

These rules influence the strategic responses of developers to forced inclusion of different social and economic groups. When forced to include tenants with wildly different tastes, developers add a “poor door” to separate their customers along class lines, just as many large, swanky buildings have service elevators to separate maintenance and delivery functions. It is easy to denounce this practice by insisting, as does Manhattan Borough President Gale Brewer, that “[b]uildings that segregate entrances for lower-income and middle-class tenants are an affront to our values” (Keil and Danika 2015). And it is equally easy to pass legislation that provides that “affordable units shall share the same common entrances and common areas as market rate units.”<sup>3</sup> But it is far harder to get people to invest money in buildings under rules that reduce anticipated returns from marketplace units. Constraints of this sort will make it far harder for Mayor de Blasio to reach his target of 200,000 affordable units in New York.

The California rules in *San Remo* are less restrictive because they allow developers to make “in lieu” payments to an affordable housing fund. But money is fungible, so the question from *Pennell* arises anew: why not use an explicit allocation of general revenues instead of non-monetized cross-subsidies with serious negative impacts? Under that regime, San Francisco can insist on its SRO replacement program only if it pays developers cash equal to the lost revenue from having to include affordable units – including both reduced revenues and higher costs. The absence of these programs is good evidence that they will fail at the local level.

The effect of this novel regime of price controls through inclusionary zoning is to contract overall supply – thereby driving out residents and raising rents. Thus in evaluating San Jose’s affordable housing ordinance in *CBIA*, Chief Justice Cantil-Sakauye never addressed Benjamin Powell and Edward Stringham’s findings on the impact of affordable housing restrictions on housing supply in San Jose (2005). That information was supplied to the California Supreme Court in explicit form by the

Amicus Curiae National Association of Homebuilders, which illustrated the negative effects of the inclusionary zoning system: “A \$1,000 increase in home price leads to about 232,447 households priced out of the market for a median-priced new home. . . . The priced-out effect is exacerbated through government regulations and constraints on housing development. Already, regulations imposed by government at all levels account for 25 percent of the final price of a new single family home built for sale.” These numbers suggest that at least in the sales market, the parties subject to affordable housing mandates cannot recover the revenue lost from the legal mandates. Clearly, the loss in supply hurts first-time homebuyers, as well as those who sell one home in order to buy another.

The Powell and Stringham study also demonstrated that the San Jose affordable housing program fell far short of expectations (2005). In the seven years before the program’s passage, 28,000 new homes were built in San Jose. In the seven years afterward, only 11,000 new units were built, of which some 770 were affordable. The tradeoff could not be clearer: is the community better off with 770 affordable units at the price of 17,000 fewer aggregate units? This looks like a terrible tradeoff, given that any supply increase lowers home prices and expands housing stock for all homebuyers, not just a select few. Fewer homes meant a smaller tax base, which in turn compromised the ability of San Jose to maintain essential services, while meeting its onerous pension obligations.<sup>4</sup> A stronger tax base could have reduced these pressures.

The adverse effects of inclusionary zoning programs are compounded by their interactions with other land use regulations that further erode the tax base. In this regard, note that the highest rates for unregulated rental housing occur in cities like New York and San Francisco (City and County of San Francisco: Residential Rent Stabilization and Arbitration Board 2015). Current rent stabilization programs privilege sitting tenants, who are locked into a unit, often with ample rights of inheritance, for indefinite renewals at stabilized prices until the current tenant on the lease dies or moves.<sup>5</sup> Rent stabilization creates a two-tier rental structure without any pretense of incorporating egalitarian values. It also contributes to the shortage in affordable housing units.

Thus in New York City at this time, rent stabilization covers about 1 million of the 2 million total rental units (Furman Center Fact Brief, Profile of Rent-Stabilized Units and Tenants in New York City 2014).<sup>6</sup> This statistic is incomplete because it does not separate out the many stabilized units in New York City that currently rent for prices below the allowable maximums, so that the price constraint does not bind. However, that proposition is decidedly not true in key areas of Manhattan and Brooklyn, where the maximum allowable rates fall far below the market rate. In Manhattan, in 2002, the gap was between \$2,285 per month for market-rate housing and \$878 for stabilized or controlled units. By 2011, the respective numbers in Manhattan were \$2,600 for the market-rate units and \$1,283 for the stabilized units. These numbers do not set out apples-to-apples comparisons, because they

do not try even in Manhattan and Brooklyn to isolate the rent-stabilized units in the high-rent areas from those elsewhere in Manhattan and Brooklyn. However, in 2015, the Rent Stabilization Board authorized a zero percent rate increase for the area. It is likely the gap between market rents and stabilized rents has increased under the influence of progressive politics in the past five or so years. In these settings, the rent differential will in all likelihood reduce the effective carrying capacity of the current usable space. An elderly widow or couple who lives in a large, rent-stabilized unit in one of the premium areas will not move voluntarily, for it is cheaper to hold on to a large unit than to rent a smaller, unregulated one elsewhere. Under a market-rate system, that person would think seriously of downsizing in order to save rent, allowing large families or groups to occupy the larger unit at market rates. The result is an effective increase in the size of usable housing stock. Opening up only 100,000 currently stabilized units could increase total occupancy by perhaps 200,000 people, just as if new stock had been built for that purpose. Rent stabilization does more than give huge windfalls to lucky tenants. It also reduces the available spots for occupation. Phasing out rent stabilization, say by allowing a 10 percent rent increase every year, will allow a smooth transition to a market-based system that will increase total supply. This in turn will exert downward pressure on rents throughout the entire system, at zero cost. Cases like *CBIA* block this development, but do so under an unsound theory of unconstitutional conditions, even under current law. The second half of this chapter analyzes the current legal situation, using *CBIA* as a template.

### 3.2 THE UNCONSTITUTIONALITY OF AFFORDABLE HOUSING PROGRAMS

*CBIA* sustained the constitutionality of the San Jose affordable housing program by insisting that it had a legitimate police power justification for its restriction on both economic liberties and private property. Its opinion marked a reversal of the victory below for *CBIA* when the superior court (trial court) held that even if the affordable housing program was for a public use, nonetheless it “determined that the city had failed to show that there was evidence in the record ‘demonstrating the constitutionally required reasonable relationships between the deleterious impacts of new residential developments and the new requirements to build and dedicate the affordable housing or pay the fees in lieu of such property conveyances’” (61 Cal. 4th 454 (2002)).

The *CBIA* court relied on *San Remo Hotel, LP v. City and County of San Francisco* (27 Cal. 4th 643 (2002)), for the proposition that:

The controlling state and federal constitutional standards governing such exactions and conditions of development approval, and the requirements applicable to such housing exactions [and] the conditions imposed by the city’s inclusionary housing



ordinance would be valid only if the city produced evidence demonstrating that the requirements were reasonably related to the adverse impact on the city's affordable housing problem *that was caused by or attributable to the proposed new developments that are subject to the ordinance's requirements*, and that the materials relied on by the city in enacting the ordinance did not demonstrate such a relationship.

Under that standard, its argument was that new housing did not displace any preexisting units, so the exaction was illegal. That argument was rejected in the Court of Appeal, which was affirmed by the California Supreme Court:

The appropriate legal standard by which the validity of the ordinance is to be judged is the ordinary standard that past California decisions have uniformly applied in evaluating claims that an ordinance regulating the use of land exceeds a municipality's police power authority, namely, whether the ordinance bears a real and substantial relationship to a legitimate public interest. (61 Cal. 4th 443 (2002))

The California Supreme Court then explained that the traditional test survived because the doctrine of unconstitutional conditions developed in *Nollan v. California Coastal Commission* (483 U.S. 825 (1987)) and *Dolan v. City of Tigard* (512 U.S. 374 (1994)) only applied to cases of "physical takings," where a property owner was required to dedicate some portion of his property to public use. It did not apply to a mere regulation under the lax *Penn Central* test. The restriction of *Nollan* and *Dolan* to possessory interests flowed easily from the Supreme Court's earlier decision in *Loretto v. Teleprompter* (458 U.S. 419 (1982)), which involved the permanent occupation of a small space on the roof of Loretto's apartment house on which Teleprompter located its cable box. Justice Marshall announced: "We conclude that a permanent physical occupation authorized by government is a taking without regard to the public interests that it may serve" (*Loretto* at 426 (1982)). In *CBIA*, the California Supreme Court refused to apply *Loretto* because, in its view, "the unconstitutional conditions doctrine under *Nollan* and *Dolan* [does not] apply where the government simply restricts the use of property without demanding the conveyance of some identifiable protected property interest (a dedication of property or the payment of money) as a condition of approval."

In essence, the same distinction that applies generally applies to cases of permit application. That extension is incorrect on both grounds. First, the purported line between physical and regulatory takings cannot withstand analysis. The two areas must be treated under a single unified conceptual frame. Second, even if that is accepted, the inclusionary zoning mandates fall on the possessory side of the line.

### 3.2.A *The Unity of Physical and Regulatory Takings*

The great conceptual challenge in takings laws is to deal with partial takings, that is, those situations where the original owner is stripped of only some, but not all the rights associated with normal outright ownership. Just that happened in both *Nollan*

and *Dolan*. In *Nollan*, the physical taking came from the requirement that the Nollans dedicate a lateral public easement across their property in order to receive in exchange an ordinary building permit. In *Dolan*, the physical taking took place when the city required the Dolans to allow both a bike path and a flowage easement across the Dolans' property in exchange for their building permit. Assume for the sake of argument that this distinction can be drawn, so that physical takings involve situations where the government either enters into the possession of private property or authorizes private individuals to do so. The question is whether the distinction matters here.

To see why it does not, it is critical to note why the unconstitutional conditions doctrine applies to physical takings cases in the first place – a point on which *CBIA* is silent. The explanation is that it is intended to prevent against widespread government abuse, akin to the situation where one private individual takes something of value from its owner and agrees to return it only upon payment of ransom money. The second transaction looked at in isolation leaves both parties better off. I prefer to regain custody of my child or my keepsake. The kidnapper or the thief prefers to keep the ransom money. But the full analysis notes that allowing the second transaction in either case will necessarily increase the likelihood of the initial kidnapping or theft – with adverse social consequences.

The same dynamic is at work in permit situations. The government could first announce that no one could build without a permit, and then agree to sell back that right to build in exchange for some fraction of the property or some easement over the whole. That process leads to widespread abuse because if the two transactions are stepped together, the government now acquires the possessory interest for itself or for some preferred private party at zero cost, a massive circumvention of the prohibition against takings without just compensation. The social distortion arises because the government now has an antisocial incentive to take private property for public use even when its value is greater in private hands.<sup>7</sup> Thus assume that the permit to build is worth \$100,000 to the landowner, while surrendering the easement will cause the owner only \$20,000 worth of loss. The temptation to surrender is overwhelming, given the potential gain of \$80,000 to the landowner. Yet if the easement in the hands of its recipient is only \$10,000, the transaction generates a social loss of \$10,000, which could be avoided if the two transactions were unbundled, so that the case for a permit had to stand on its own, separate from the condemnation of the easement.

At this point, it is critical to note the two key limitations on the permit power are “nexus” and “rough proportionality” – the public law analogs to the private law requirements of legitimate ends and appropriate means. On the first point, the state must show some justification for the restriction it imposes, for which its own benefit is never sufficient. In practice, there are only two ends that justify this state use of its monopoly permit power. The first is to prevent the commission of a nuisance or other tort. At this point, the state only asserts the same powers available to private parties who likewise can enjoin the commission of the nuisance, typically without

paying compensation. This line of argument folds into the traditional police-power justification for the protection of health and safety. Alternatively, the state can impose the restriction if it can demonstrate that it has compensated the owner in kind for the loss that it has imposed, at which point the social losses that arise from bundling do not occur. In neither of these two cases is there the risk of the types of abuse that can flow from the power to improperly reduce the returns to investment in new housing.

For all public acquisitions that do not fall into these two classes, the government has to pay for them out of general revenues. Thus it is one thing to require a landowner to take precautions to prevent pollution run-off from his own lands. It is quite another to insist, as in *Dolan*, that he grant the easement to control the run-off from the land of some independent third party, where the state action is no more legitimate than a revised tort rule that makes A pay for the wrongs of an unrelated B. Indeed, just this distinction is routinely developed and applied under state law cases that allow for impact fees to control potential nuisances, but not to fund various activities like new schools that should be paid for out of general revenues.<sup>8</sup>

Once the legitimate ends are specified for takings cases, the next inquiry asks whether there is “rough proportionality” between the means and the ends, in order to ensure that common improvements are paid for from common funds. Thus in *Koontz*, it was improper for the state to condition its permit on the willingness of *Koontz* to either fix or pay for fixing a broken culvert located upstream along the river. Those expenditures belong on the public books to ensure public officials properly weigh all the relevant benefits and burdens to prevent the overproduction of asserted public goods by an implicit in-kind subsidy levied on one party.

The political risks with implicit subsidies are not confined to possessory interests, but apply to any and all land use restrictions. Thus the same set of considerations applies with equal force to height or setback restrictions. They also apply to the various in lieu fees used in *San Remo* and in *Koontz*. Covering all forms of exactions by the same two-part test eliminates the gamesmanship that arises when the government attempts to circumvent important restrictions by using one technique instead of another.<sup>9</sup> The endless fragmentation of government strategies to evade this mandate opens the door to massive political abuse. Is there any meaningful difference between the government asking for the lateral easement or for \$20,000 that it turns around to buy that easement? Or in using that money to condemn a restrictive covenant that restricts the height of the Nollans’ new house to 10 feet? The private law has long regarded both easements and restrictive covenants as part of the unified branch of servitudes, and there is no reason to deny them like protection under the takings law. Paying cash is an important revelation device that establishes that the easement, or the restrictive covenant, is worth more to the state than to its private owner. Unbundling the easement or restrictive covenant from the permit stops the potential government abuse cold, because the property interest will only be taken if its perceived value is greater than its cost.<sup>10</sup>

Accordingly, it is easy to see the danger from any switch to the laxer standard that asks about “the real and substantial relations to the public welfare.” Historically, this standard draws on *Nebbia v. New York* (291 U.S. 502, 539 (1934)), which enshrined the rational basis test in cases of economic liberty. Under that test, San Jose’s preexisting conditions do not matter at all. So long as the legislature thinks it has taken steps to expand the supply of some class of affordable housing, it has met the constitutional standard. Under *CBIA*, the simple observation that the chosen standard is likely to prove counterproductive is irrelevant to the current system of constitutional law. It is for the legislature to decide on the merits of the means–ends connections, so it is perfectly proper for the Court to bypass without so much as a single word of comment the earlier study by Powell and Stringham, because there is no constitutional issue to which the demonstration of major economic dislocation is directed.

A closer analysis shows how using the lower level of judicial scrutiny led the California Supreme Court badly astray in both *San Remo* and *CBIA*. In *San Remo*, the Court used this test to uphold the requirement that the developer either build similar units at some other (undetermined) location within the city, or alternatively, that he contribute money into an “in lieu” fund that the City thereafter would use exclusively for the purpose of developing long-term housing. The new requirement was regarded as “reasonably related to mitigating the impact that the landowner’s proposed conversion would have on the preservation of long-term rental housing in the city” (*San Remo Hotel* at 87 (2002)). The use of the term “mitigating” says it all. Where is the wrong that needs to be mitigated? Normally mitigation is required to offset some prior wrong. But here the tenant has no property interest that is violated by any action of the landlord, for the refusal to renew any short-term lease is not a wrong to the tenant, but the exercise of the retained right of the landlord, who may exercise its common law right to regain possession of the property at the end of the lease, on the ground that the holdover tenant is a trespasser who gains no rights by his wrong against the landlord, as holder of the reversion.<sup>11</sup> The attitude toward displacement thus explains all forms of rent stabilization and rent control laws, whether they operate on the wholesale or retail basis. In order to close that gap, New York law, consistent with the California approach, requires that all new projects consider “the potential displacement of local residents and businesses, [which count] as an effect on population patterns and neighborhood character.”<sup>12</sup>

This huge expansion in the definition of harm has literally zero connection to the nuisance prevention rationale applied under the traditional police-power justifications. Under this definition, the question is never whether there are externalities justifying the triggering of public force. It is a virtual certainty that any reduction in existing stock will produce some changes in quantity and price that count as a deleterious effect. Accordingly, the *San Remo* ordinance is necessarily valid, because the displacement of any long-term resident counts as an adverse effect sufficient to trigger administrative relief, at least if the state is

prepared to supply it. There is no way that this requirement satisfies either the “nexus” or “rough proportionality” tests of the *Nollan/Dolan* line of cases, which is why resort to the *Penn Central* test is so critical.

At this point, the element of choice between the replacement units and the in lieu fee is quite irrelevant. As Justice Holmes said long ago: “It always is for the interest of a party under duress to choose the lesser of two evils. But the fact that a choice was made according to interest does not exclude duress. It is the characteristic of duress properly so called” (*Union Pac. R.R. Co. v. Pub. Serv. Comm’n of Mo.*, 248 U.S. 67, 70 (1918)). Of course the in lieu fee is, *ceteris paribus*, likely to be far more attractive to the developer than requirement of new construction, which requires the developer to run the gauntlet of the many zoning and other ordinances that stand in the path of new construction throughout San Francisco. No wonder the developer in San Remo first paid a \$567,000 in lieu fee, which he properly sought to recover as a payment made under duress.

From a social point of view, moreover, the San Remo ordinance does not produce any social gains that justify its massive administrative costs. In *San Remo*, no one doubted that the increase in available short-term housing for tourists was essential for the continued growth of one of San Francisco’s key industries. So this is not a case of property going from a higher- to a lower-value use. Quite the contrary, the set of suitable locations for tourists is much more restricted than the space for long-term housing. Wholly apart from any long-term tenant protection, the shift in land use should generate net social gains.

It is equally clear, however, that this change will not generate a Pareto improvement because the displacement of sitting tenants produces large losses for multiple reasons. First, these tenants have locational benefits that are difficult to duplicate elsewhere, including a wide array of support services and social relationships that are location-bound. Second, finding accommodations in other neighborhoods is no easy feat when housing markets are uncommonly tight because San Francisco’s baroque land use regulations block the new construction that could ease the loss, not only for tenants who are displaced by tourist housing, but also to any and all tenants who are displaced at all. So the *San Remo* standard compounds the blunder by blocking the landlord’s right to reclaim premises at the end of any lease. In so doing, it takes the law in the wrong direction. The only structural solution to the problem of displaced tenants requires San Francisco to remove the restrictions on supply by allowing freer entry of new housing, including the conversion of other kinds of units, if appropriate, into rental housing. The sad truth is that dislocation losses are compounded by giving inordinate protection to sitting tenants elsewhere. Yet this added round of restrictions will in the end lead to the decline of tourist housing and a shortage of new rental units, accounting in part for the sky-high rentals found throughout San Francisco. No effort to constrain housing supply will produce distributional gains sufficient to offset the allocative losses.

With this said, the superior court was probably right in holding that the San Jose ordinance went too far under the *San Remo* test. That standard was tailored to meet the situation at hand, i.e., one in which individual tenants had been displaced. The San Jose ordinance did not apply to existing tenants, but only to new housing, removing the displacement of existing tenants from the equation. Filling in of vacant land presents an easier social problem than displacing tenants. So the ordinance in *CBIA* went beyond what was decided in *San Remo* by requiring affordable housing concessions from developers undertaking the construction of new units even when no old ones were removed from the marketplace. That rule applies even for projects that only increase, as noted, the long-term supply of housing that is so critical to improving the overall situation.

### 3.2.B The Higher Scrutiny of *Nollan and Dolan*

At this point, the only challenge left to the California Supreme Court in *CBIA* was to justify its unwillingness to apply *Nollan* and *Dolan*. In my view, ignoring those two cases was improper because its overall analysis depended on it giving an indefensibly narrow reading of the *Loretto* test that requires per se compensation when there is a permanent loss of possession. According to *CBIA*, that test does not apply whenever the state “simply restricts the use of property without demanding the conveyance of some identifiable protected property interest (a dedication of property or the payment of money) as a condition of approval.”

The key mistake here is that the court misdefines a land use restriction as that term was used in *Penn Central*. Correctly understood, the government in those cases does not change the party in possession but only limits the way in which that party can use what he possesses. Hence the restriction of new construction in *Penn Central*. But the inclusionary zoning cases are not just restrictions on how the property is used. They are also explicit restrictions on who can use the property. In the *Loretto* situation, the government told Loretto that she had to allow Teleprompter onto its premises. In the inclusionary housing cases, the government does not identify who shall go into any affordable housing unit. And it does not indicate which units shall be open to some member of the protected class. But it does make very clear that it authorizes some individuals to enter some units at below-market rates. The fact that the government gives the developer the option to decide which unit shall be turned over to a particular tenant does not convert that mandated occupation into a simple restriction on land use. It is still the possessory taking of a particular unit that will be specified not at the time the project starts, but when it is completed. The additional element of choice does not convert a physical taking into a regulatory one. It only allows the landowner to mitigate losses, and thus to reduce the level of compensation owed by the state.

The key mistake in *CBIA* derives from the confused concurring opinion of Justice Kennedy in *Eastern Enterprises v. Apfel* (524 U.S. 498, 540 (1998)), which insisted that the Takings Clause does not apply because the Coal Act “does not appropriate,

transfer, or encumber an estate in land (e.g., a lien on a particular piece of property). [It] simply imposes an obligation to perform an act, the payment of benefits.” He therefore concluded that the retroactive imposition of huge taxes to fund health care benefits for retirees in the coal industry “must be invalidated as contrary to essential due process principles, without regard to the Takings Clause of the Fifth Amendment” (*Eastern Enterprises* at 539 (1998)). Note that the word “property” is not used in this capsule summary of the due process claim, because Justice Kennedy believed a general charge on the revenues of certain energy companies called for a higher level of due process scrutiny, because it singled out unpopular groups or individuals. The conclusion is sound. The argument is not.

First, the Due Process Clause requires that the claimant be asked to surrender “life, liberty or property.” It follows therefore that the absence of any property interest removes the protection of the Due Process Clause. But if the want of an identifiable interest does not block the application of the Due Process Clause, it cannot block the application of the Takings Clause either. The retroactivity concern applies equally to both, which in turn requires asking the two questions about the police power and implicit-in-kind compensation relevant in all takings cases. The former does not apply in *Eastern Enterprises* given that the forced contributions to the black lung disease programs were imposed on firms that had long been out of the coal business. Yet while they were in business, they had complied with all their legal obligations. Similarly, that program generated no return benefit to these firms. Hence we have the pure net loss that the Takings Clause prohibits. General revenues, not special assessments, should cover these expenses if they are to be covered at all. The prohibition against retroactive liability blocks the impermissible burdens on private firms for public benefits. The analysis is identical under both the Takings and Due Process Clauses.

Second, as a matter of private law, the want of identifiable property interests is no obstacle to the protection of property interests. Many businesses commonly use floating liens that allow the borrower to use property freely, especially inventory, until some default occurs, after which the lien attaches to the assets that remain in the possession of the debtor up to the amount of the lien.<sup>13</sup> This device increases the value of the business and thereby reduces the likelihood of default – a win/win situation. But on default that lien is possessory and should be fully protected under *Loretto*.

A similar strategy is involved with taxation. The government identifies the total tax base and then lets the taxpayer pick whatever assets it wants to satisfy the bill – a floating lien. But once the taxes are not paid, the government can attach its tax lien to whatever property it chooses in order to discharge the debt. Taxes and takings do not fall into different worlds, for there is no conceptual gap between them.<sup>14</sup> The key difference comes in on the *benefit side*, where the taxes are justified by the in-kind benefits in the form of public goods.

Indeed, the logic of *Loretto* also covers any case where government forces the owner off the land that it then declines to occupy, which is what it did in *Penn Central* when it kept the owner from using the air rights, without using them itself. It is

incomprehensible that the government should be allowed to avoid paying any compensation at all if it chooses to leave the air space empty, but must pay full compensation if it develops it in some modest way. Conservation easements often leave land undeveloped. In this case, the difference, if any, goes to the issue of valuation, where the loss to the owner is somewhat smaller (because of the preservation of view and light) if the government leaves the air rights empty than if it builds (Epstein 2013). But there is no on-off switch that tracks the requirement of compensation, or not in such a minute difference.

As has been hinted before, *Loretto* also applies with full force to all rent control and rent stabilization statutes. In the majority opinion in *Yee v. Village of Escondido* (503 U.S. 519 (1992)), Justice O'Connor claimed that the typical rent control statute involved only a regulatory taking, not a physical taking under the *Loretto* rule. Her argument was: "On their face, the state and local laws at issue here merely regulate petitioners' use of their land by regulating the relationship between landlord and tenant" (*Yee* at 528 (1992)). But her logic is a transparent misuse of the word "use." She thus manages in a single sentence to upend 1,000 years of property law. Clearly the tenant in *Yee* has possession of the premises, and his entry was authorized by the government under *Loretto*: after all, the basic rent control law found it "is necessary that the owners of mobile homes occupied within mobile home parks be provided with the unique protection from actual or constructive eviction afforded by the provisions of this chapter" (Mobilehome Residency Law, Cal. Civ. Code Ann. § 798 (West 1982 and Supp. 1991), § 798.55(a)). Justice O'Connor cannot deny that a rent control tenant, any more than an affordable housing tenant, is in possession, so she shifts grounds to insist that landlords "voluntarily rented their land to mobile home owners" (*Yee* at 527 (1992)). But the lease was for a year, not in perpetuity, so that the tenant is, as noted earlier, a holdover tenant who can be evicted as of right. It follows therefore that the affordable housing program, by forcing landowners to set aside given property for tenants or buyers, results in a possessory taking as that term was used in *Loretto*. The huge loss in capital value is not compensated in kind by the supposed right to evict a tenant, so long as the landlord is prepared to convert the property to some lower-valued use when the applicable constitutional standard under *Monongahela Nav. Co. v. United States*, 148 U.S. 312, 325 (1893) requires "a full and just equivalent" for the property surrendered. The simple point is that the rent control statutes and the affordable housing legislation are both possessory takings, and hence out from under the *Penn Central* rule.

#### CONCLUSION

In this chapter, I have explored both the economic and constitutional rationales for inclusionary zoning programs. The economics of this area show that the perverse incentives created by the various set-aside programs have a negative effect on overall welfare. For the gain of a few affordable units, the entire housing system is thrown



into major forms of disarray that result in fewer housing units available at all levels of income. The takings analysis starts with an abstract commitment to the protection of private property against expropriation, but it too marches off in the same direction.

Once the Takings Clause is understood to cover all takings of partial interests, the inquiry then turns to sensible justifications for takings, of which the control of nuisances is the major one in land use contexts. Nothing of this sort is at issue in the affordable housing set-asides. The next question is whether compensation is provided for the losses in question, to which the answer is always negative. Once these connections are established, the inability to find either cash or in-kind compensation in affordable housing cases should be their constitutional death knell. Why allow any program to go forward that promises losses in excess of gains? But if the economic analysis is clear, the constitutional analysis in both federal and state courts is a hopeless tangle of transient distinctions and pained rationalizations of confiscatory programs that give little help to their intended beneficiaries but cause much social dislocation for everyone else. They are strictly dominated by a program that either removes entry barriers to new housing, or uses direct subsidies to support it. The popularity of these programs proves that their political salience is inversely correlated with their social welfare. They should be terminated forthwith.

#### AUTHOR'S NOTE

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 Mobilehome Residency Law, Cal. Civ. Code Ann. § 798 (West 1982 and Supp. 1991), § 798.55(a)  
 N.Y. Envtl. Conserv. Law §8–0105  
 N.Y. Real Property Tax Law Section 421-a, amended by Chapter 20 of the Laws of 2015, available at [www1.nyc.gov/site/hpd/developers/tax-incentives-421a-main.page](http://www1.nyc.gov/site/hpd/developers/tax-incentives-421a-main.page)  
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 Furman Center Fact Brief, *Profile of Rent-Stabilized Units and Tenants in New York City*, Table C for various areas, available at [http://furmancenter.org/files/FurmanCenter\\_FactBrief\\_RentStabilization\\_June2014.pdf](http://furmancenter.org/files/FurmanCenter_FactBrief_RentStabilization_June2014.pdf)  
 Investopedia, [www.investopedia.com/terms/f/floating-lien.asp#ixzz48CXoKlnC](http://www.investopedia.com/terms/f/floating-lien.asp#ixzz48CXoKlnC)  
 NYC Rent Guidelines Board, Succession Rights FAX, available at [www.nycrgb.org/html/resources/faq/succession.html](http://www.nycrgb.org/html/resources/faq/succession.html)

### Notes

1. See *Brooks-Scanlon Co. v. Railroad Commission*, 251 U.S. 396 (1920) (holding that gains from nonregulated activities cannot be used to offset shortfalls from regulated businesses); *Board of Public Utility Commissioners v. New York Telephone Co.*, 271 U.S. 23 (1926) (holding it impermissible to allow losses in the current period to be offset by the promise of future profits).
2. I have critiqued this article in Epstein (2016).
3. Chapter 20 of the Laws of 2015, amending New York Real Property Tax Law Section 421-a, [www1.nyc.gov/site/hpd/developers/tax-incentives-421a-main.page](http://www1.nyc.gov/site/hpd/developers/tax-incentives-421a-main.page).
4. Note that San Jose’s sensible pension reform ordinance was struck down in *San Jose Police Officers’ Association v. City of San Jose*, No. 1–12-CV 225926 (Consolidated with Nos. 1–12-CV 225928, 1–12, CV-226570, 1–12-CV 226574, 1–12-CV 227864 & 1–12-CV-233660) (Super. Ct. Santa Clara Cnty. Dec. 20, 2013) (unreported tentative decision), under a rule whereby “the right to a pension vests upon acceptance of employment.” *Kern v. City of Long Beach*, 179 P.2d 799, 801 (Cal 1947) For my critique, see Epstein (2015a, 888–900).
5. See NYC Rent Guidelines Board, Succession Rights FAX, available at [www.nycrgb.org/html/resources/faq/succession.html](http://www.nycrgb.org/html/resources/faq/succession.html).

6. Furman Center Fact Brief, Profile of Rent-Stabilized Units and Tenants in New York City, Table C for various areas, available at [http://furmancenter.org/files/FurmanCenter\\_FactBrief\\_RentStabilization\\_June2014.pdf](http://furmancenter.org/files/FurmanCenter_FactBrief_RentStabilization_June2014.pdf).
7. For more detailed discussions, see Epstein (1995, 2015a).
8. See, e.g., *Drees Company v. Hamilton Township*, 970 N.E.2d 916 (Ohio 2012) (rejecting as disproportionate an impact fee from developers for roads, parks, and fire and police protection); *Daniels v. Borough of Point Pleasant*, 129 A.2d 265 (N.J. 1957) (same). In contrast, see *State ex rel. Petroleum Underground Storage Tank Release Comp. Bd. v. Withrow*, 579 N.E.2d 705 (Ohio 1991) (allowing special fees to counter the risk of petroleum releases from underground storage facilities).
9. For discussion, see Epstein (2014). The principal applies to takings *Pumpelly v. Green Bay Co.*, 80 U.S. 166 (1872); searches and seizures, see, e.g., *Katz v. United States*, 389 U.S. 347 (1967); and the first amendment, see, e.g., *New York Times v. Sullivan*, 376 U.S. 254 (1964).
10. For fuller expositions, see Epstein (1995, 2015a).
11. “As a general rule, a tenancy from year to year is created by the tenant’s holding over after the expiration of a term for years and the continued payment of the yearly rent reserved. . . . By remaining in possession of leased premises after the expiration of his lease, a tenant gives the landlord the option of treating him as a trespasser or as a tenant for another year.” Thompson on Real Property § 1024, at 65–66 (1959). See also *Crechale & Polles, Inc. v. Smith*, 295 So. 2d 275 (Miss. 1974).
12. For a similarly broad law, see N.Y. Envtl. Conserv. Law §8–0105.
13. “A legal claim placed on a set of assets rather than on a single asset,” such as accounts receivable that fluctuate over time. Investopedia, [www.investopedia.com/terms/f/floating-lien.asp#ixzz48CXoKlnC](http://www.investopedia.com/terms/f/floating-lien.asp#ixzz48CXoKlnC). For a general discussion, see Harrington (1980).
14. For discussion, see Epstein (1985).

