Auctioning the Upzone:

A New Strategy to Induce Local Government Compliance with State Housing Policies

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Table of Contents

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Executive Summary

In January of 2018, California state senator Scott Wiener shocked the political firmament with a bill that would have zoned every tract of land in the state near a bus, rail, or ferry stop for 8-10 story buildings.[1] His bill, SB 827, was soon watered down and then defeated, but not before launching a national debate about housing costs, "NIMBYism," and the critical importance of increasing residential density near mass transit.[2]

Though SB 827 was uniquely far reaching, it was not a one-off. Sen. Wiener has introduced a very similar successor bill, SB 50, for the 2019-2020 legislative session,[3] and a state senator in Washington has floated a proposal to establish density minimums around transit stations in the greater Seattle region.[4] Out of the limelight, state housing agencies and to some extent state courts are also pressing local governments to allow denser housing.[5]

The debate thus far about state-mandated upzoning has centered on questions about the proper balance between statewide vs. local interests. An equally if not more important question has received too little attention: what will it take to get local governments—the entities that actually issue building permits—to comply with the state's policy? SB 827 did nothing to displace local control over permitting, design standards, demolition restrictions, impact fees, affordable-housing requirements, and more.[6] SB 50, the successor bill, is no different. If the bill passes, localities that don't want tall buildings near transit could make them incredibly difficult if not impossible to build.

The history of state efforts to make local governments allow more housing is a history of mostly-minor interventions that were met, swamped, and defeated by local champions of the status quo. A bold, state-led upzoning program is unlikely to achieve very much unless it is paired with an equally bold mechanism to secure local governments' cooperation.

In principle, a state could induce cooperation by threatening severe penalties. But local control over land use is politically popular,[7] making stiff penalties hard to enact and even harder to apply. Alternatively, the state could bribe local governments, subsidizing localities which rezone in conformance with state law. But upzoning subsidies would compete with other budgetary priorities, and incentive programs have often received the axe during economic downturns. Subsidies might also engender more gamesmanship than actual development, with local governments applying for state funding on the basis of upzoning or capital improvement plans they are not prepared to implement.

Bearing these constraints in mind, we propose a new path forward: States should confer on local governments the right to auction development rights created by upzoning pursuant to state policy. This is akin to a state subsidy, but it would come at no cost to the state's budget, and, critically, the size of the subsidy—that is, the revenue generated for the local government through the auction—would depend on the *credibility* of the local government's commitment to allowing development in the upzoned area. Our proposal would also facilitate state monitoring of local land-use regulation, as the price at which development allowances trade would provide a forward-looking signal about otherwise hidden or obscure local barriers to development.

Though our proposal is novel, it has a near analogue in existing transferable development rights (TDR) programs. The principal difference is that TDR programs reallocate development value among landowners, whereas our program would reward local governments for upzoning by allowing the government to recoup the development value thereby created.

I. The Problem of Local Noncompliance with State Housing Policies

In the early 1980s, California declared a crisis of housing affordability, rightly placing the blame on local governments' exclusionary, anti-development policies.[8] As a corrective, the legislature passed the Housing Element Law of 1980, which empowered the state Department of Housing and Community Development (HCD) to set minimum housing quotas for which local governments were required to plan. In 1982, the legislature enacted the Housing Accountability Act, which curtailed local discretion to deny or reduce the density of many projects, and another bill requiring local governments to allow so-called "accessory dwelling units" (ADUs) on parcels zoned for residential use.

Since then, California has become the national posterchild for housing policy dysfunction.[9] What went wrong? Almost everything. Most local governments are dominated by homeowners.[10] Homeowners have a financial incentive to restrict the supply of new housing, and they generally like their neighborhoods the way they are. Answering to such constituencies, local governments flaunted the new state mandates. Many refused to update and submit their housing plans for state review, or if they did, frankly acknowledged that they had no intention of permitting the housing for which they had "planned."[11]

Studying local implementation of California's ADU legislation, law professors Margaret Brinig and Nicole Garnett concluded that most cities had effectively thwarted it with a "thousand paper cuts."[12] Fed up with local insubordination, California in the last couple of years has stripped away most every residue of local control over the siting and regulation of ADUs.[13] This is making a difference, finally.[14] But such wholesale state takeovers would not be tenable for more visible and socioeconomically transformative upzonings, such as Sen. Wiener's SB 827.

II. Achieving Compliance through Upzoning-with-Auctions

A. The Model

Under the framework we propose, local governments that upzone in furtherance of state policy—e.g., to meet their housing quotas, or to comply with density-near-transit bills like SB 827—could apply to a state agency, such as California's HCD, for permission to auction the newly created development rights. These would take the form of tradeable "development allowances," roughly analogous to the emissions allowances that are now bought and sold under California's cap-and-trade regime for greenhouse gas emissions.[15] Just as the owner of a power plant who wishes to burn fossil fuels must purchase emissions allowances for the carbon dioxide that would be released, so too would a landowner who wishes build in the expanded zoning envelope have to acquire and redeem development allowances.

To maximize revenue from development-allowance auctions, the local government (or a consortium of local governments) could delimit market zones within which housing is of roughly equal value. Development allowances would be fungible within but not between these zones. A developer who seeks to build in downtown San Francisco, for example, would have to redeem "city center" development allowances, rather than the presumably much cheaper allowances for building in outlying areas.

Each development allowance would permit its owner to build, say, 100 square feet of housing in excess of the baseline, up to a maximum defined by the new zoning map. To illustrate, imagine a parcel of 2500 square feet that had been zoned for a floor-to-area ratio of two, i.e., two square feet of housing for every square foot of lot size. Let us stipulate that after upzoning, the maximum floor-to-area ratio is eight. This means that the owner of the parcel, who previously could build no more than 5000 square feet, may now construct as many as 20,000 square feet. But to obtain a permit to build 20,000 square feet, she would have to acquire and redeem 150 development allowances ([20,000 – 5000]/100 = 150).

To protect landowners' reasonable expectations, the state legislature should carefully define the development baseline—that is, the minimum level of development for which local governments *may not* demand development allowances. A landowner who seeks only to build something similar to what most others have already built should not have to pay for the privilege.[16] Nor should local governments make landowners pay for the density allowed under longstanding zoning classifications. Accordingly, we recommend defining the baseline as the greater of (1) the typical density of parcels that have already been developed for housing within the local government's territory, and (2) the locally permitted density for the parcel in question as of the date of the state law authorizing the auctions.

Tradeable development allowances would have a fixed lifespan. In California, their lifespan might be tied to the eight-year cycle on which the state requires local governments to plan for needed housing. Allowances not redeemed within their lifespan would expire. Additionally, the market in development allowances must be regulated to limit the risk of monopolization.[17] California is well positioned to address these matters, having worked through analogous issues in its cap-and-trade program for greenhouse gas emissions.

Our upzoning-with-auctions model bears a family resemblance to existing transferrable development rights (TDR) programs. Under a TDR program, the zoning authority designates separate "sending" and "receiving" zones, and gives landowners in the sending zone tradeable development credits which are only usable by landowners in the receiving zone.[18] Receiving-zone landowners who purchase these chits are allowed to build in excess of the otherwise-permitted density on their sites. TDR programs are, in effect, a way to redistribute among landowners the value created by selective upzoning, where the "upzone" takes the form of permission to build in the receiving zone above the otherwise-allowable density. Professors Rick Hills and David Schleicher have explained that TDR programs can be used to assemble local political coalitions in favor of upzoning.[19] Our proposal builds on this insight, while giving local governments much greater flexibility to allocate the economic surplus from upzoning.[20]

B. The Auction as a Compliance Mechanism

Without forcing local governments to issue development permits, our model would nonetheless foster compliance with state policy in several ways.

1) Compliance Through Positive Incentives

First and most obviously, our model would give local governments a direct financial stake in permitting dense new housing in areas targeted by the state. This financial incentive would be greatest where new development would be most valuable, and it would encourage local governments to permit zoning-compliant projects with minimal rigmarole.

The theory of zoning originally presupposed that projects conforming to objective requirements—height, bulk, setbacks, use, etc.—would be permitted "as of right." Yet in high-cost housing markets, development permitting has become thoroughly discretionary, requiring project-by-project negotiations over design, scale, public benefits, affordable housing set asides, and so much more.[21] Local governments and neighborhood NIMBYs use this discretion to kill projects they dislike, and though some projects make it through, the delays and uncertainties can be very costly.[22]

Under our model, the high cost of discretionary permitting would be borne by the local government itself, in the form of foregone revenue. Bidders wouldn't offer very much for development allowances that merely license the owner to negotiate with a local government, whereas allowances that function as entitlements to build would be enormously valuable in the high-cost, supply-constrained markets that are increasingly characteristic of big cities today.[23]

The right to auction development allowances would therefore give cities a powerful incentive to reform their development-permitting protocols, in line with the original theory of zoning. And the state could facilitate this by making local commitments undertaken in connection with the auctions enforceable as state law. For example, as part of its auction plan, a local government might adopt strict time frames for reviewing development proposals within the upzoned areas, with a proviso that if the government fails to complete its review by the appointed hour, the project shall be deemed approved as a matter of law.[24] If the local government proposes to make this commitment enforceable as state law, and the state agency concurs, then developers could continue to enforce it even if the locality later passed an ordinance reneging on its commitment.

2) Compliance Through Better State Oversight of Local Regulatory Barriers to Development

In addition to providing local governments with a direct financial inducement to allow dense housing in upzoned areas, our upzoning-with-auctions model would bolster state oversight of local land-use regulation. By monitoring the gap between development-allowance prices and finished-housing prices, state housing agencies and courts would acquire valuable information about which local governments probably have substantial (and perhaps hidden) constraints to producing high-density housing, and whether local programs to remove constraints are likely to work.

In a competitive market, the difference between the price per square foot of new housing and the market price of the corresponding development allowance should roughly track the cost of construction. Economists have found that non-regulatory construction costs are pretty similar across jurisdictions.[25] So if the gap between allowance prices and finished-housing prices proves to be much bigger in some cities than in others, this would be flashing yellow signal that the high-gap jurisdictions may have particularly onerous regulatory and procedural barriers to developing nominally-permitted housing.

Of course, significant between-city differences in the gap between finished-housing and development-allowance prices could also arise from many factors beyond the local governments' control. Development allowances are likely to be worth less, for example, in a jurisdiction whose undeveloped or redevelopable sites consist of small, heavily polluted, and steeply pitched tracts of land, relative to an otherwise similar jurisdiction with large tracts of flat, uncontaminated, easily developed land.

Nor is a market in development allowances strictly necessary to provide a price signal about local regulatory barriers. Such barriers are already reflected to some extent in the price of land.[26] Developers will pay less for land in jurisdictions with cumbersome, time-consuming permitting arrangements, relative to land in otherwise similar jurisdictions with an easy, speedy permitting procedures. As well, in jurisdictions with a cumbersome permitting process, parcels with building entitlements in place will sell for much more than the same parcel without entitlements.

But the development-allowance market is likely to provide a cleaner signal about regulatory costs than the market in developable land. Transactions in developable land occur relatively infrequently, in part because the transaction costs are high. (Owners of land may face liability for hazardous waste cleanup, among other things, and in California, property sales reset the parcel's tax basis.) Even when two transactions of the very same parcel are observed, the first without and the second with building entitlements in place, the difference in price may reflect not simply the entitlement, but also the removal of impediments to redevelopment (e.g., existing structures, long-term tenants), the buyer's acquisition of nearby, complementary parcels, or simply new information about the parcel's underlying condition (e.g., soil stability, hazardous waste).

Compared to the market in land, the development-allowance market should be more liquid, standardized and transparent. Allowances could be bought and sold without exposing the buyer to any parcel-specific liabilities. Allowances, unlike parcels of land, would be fungible within market zones. Allowances, unlike land, would not come with property tax obligations that reset on sale. Each allowance would entitle its owner to exactly the same thing: the opportunity to build a given number of square feet, within the new zoning envelope and above the development baseline, on any parcel within a defined geographic area.

The summative signal of regulatory costs provided by the market in development allowances would be particularly valuable in California, owing to other facets of state law. California requires local governments to periodically update and submit for state review the "housing element" of their general plans, detailing how they will accommodate their share of regional housing needs over the next eight years.[27] The housing element must identify public and private constraints to producing locality's share of new housing, and set forth an action program to remove constraints.[28]

The forward-looking signal about regulatory constraints provided by the development-allowance market would complement the retrospective information that California now requires local governments to provide: annual reports on development applications, entitlements and building permits, and certificates of occupancy.[29] This information is very useful, but when the state housing agency exercises its authority to certify or decertify a housing element, it is supposed to make a forward-looking judgment about whether the local government *will* meet its housing obligations, not a backward-looking judgment about how the jurisdiction has performed to date. Market participants are forward looking too—bids on development allowances will reflect their expectations about the ease or difficulty of building in the future—and so the information conveyed by development-allowance prices will be especially useful for state oversight of local housing plans.[30]

3) Ancillary Effects

Our upzoning-with-auctions model would subtly change the dynamics of setting and allocating regional housing quotas. California currently establishes these quotas through negotiations between regional "councils of government" (COGs) and the state housing agency. COGs then allocate their respective quotas among the member governments. COGs presently face incentives to lobby for the smallest possible regional quotas, and COG members try to minimize their shares, because local governments that fail to meet their quotas forfeit some permitting discretion.[31] But if local governments could auction the development rights created by upzoning to meet their quotas, the politics would play out differently. Local governments with high housing prices—and thus the most to earn through development-allowance auctions—would have a financial stake in lobbying for bigger quotas. The likely result is more housing, and a more efficient allocation of that housing within regions.

Our upzoning-with-auctions model should also make bills like Sen. Wiener's SB 827 easier to enact in the first place, not just more effective once enacted. Opponents of Sen. Wiener's bill blasted it as a giveaway to developers, a gift of upzoning with nothing demanded in return.[32] Our model ensures that local governments can capture and repurpose much of the economic surplus from upzoning. By packaging an upzoning mandate with a local "right to auction" the newly authorized development rights, state lawmakers can soften resistance from the (big-spending[33]) local government lobby.

III. Objections

Our proposal is open to three sorts of objections. One is that the benefits are overstated, because local governments already have tools at their disposal for extracting the value created by upzoning. Another is that the model would violate state or federal law. Third, one might worry that the model would backfire, perhaps by discouraging cities from voluntarily upzoning land in circumstances where the upzone is not "pursuant to state policy," or by inducing cities that have won the state's approval for their auction to lobby against upzoning by other municipalities in their region.

A. Would Auctions Be Superfluous?

We readily acknowledge that local governments already have a variety of devices for extracting development value. But the right to auction development allowances would hardly be superfluous, because the other tools for extracting value destroy a lot of it in the process.

Instead of selling upzoning for cash, local governments nowadays extract value indirectly and opaquely, through in-kind property exactions, impact fees, affordable-housing mandates, union-wage requirements, and more. Cities may also secure a virtually unlimited range of improvements and concessions through ad hoc "development agreements," in which the city curtails its power to make future regulatory changes with respect to the developer's project in exchange for the developer's provision of specified public benefits. Some value extraction is also outsourced, *de facto*, to community and neighborhood groups, which pressure developers to sign "community benefit agreements" in which the developer transfers property or other goods in return for the group agreeing not to challenge the project's approval.

Yet the in-kind benefits provided by developers are worth less to local governments than their cash equivalents; endless rounds of review and negotiation are costly for everyone involved; and information asymmetries between local governments and developers sometimes result in cities demanding too much (inadvertently killing projects) or too little (getting fleeced).

The reason for this wasteful indirection is that courts and legislators have long resisted the explicit exchange of rezoning for cash. "Zoning for dollars" has been derided by partisans on the left as corrupt (selling out the public interest to the highest bidder), and by partisans on the right as exploitative (taking from landowners what is rightfully theirs).[34] Courts accordingly curtailed the relatively straightforward modes of value-extraction: impact fees and property exactions.[35] Yet the concessions that local governments and interest groups obtain through ostensibly voluntary contracts—that is, development and community-benefit agreements—have escaped judicial scrutiny.[36]

The lesson for the strategic local government is clear: Set up a prolonged, discretionary review process, and get in the habit of changing the applicable rules long after a developer has submitted her permit application. This will make it very difficult for developers to plan and finance their projects, and they'll pay through the nose for regulatory certainty in the form of a development agreement that fixes the rules for their project. Alternatively or in addition, create lots of procedural hooks for neighborhood groups to initiate hearings, demand studies of a project's impact, pursue internal appeals, and otherwise delay projects. To avoid these costs and delays, developers will gladly "donate" value through privately negotiated community-benefit agreements.[37]

The outsourcing of value extraction via community-benefit agreements (CBAs) is particularly concerning, as it gives rise to a collective-action problem among would-be value extractors. Different interest groups and neighborhood organizations will have different priorities, as well as different beliefs about what the developer of a project can afford to pay. Each group, if it can credibly threaten to delay the project via appeals or litigation, has an incentive to hold out for a bigger piece of the pie. But from the developer's perspective, the agreement isn't worth much at all unless it binds *everyone* who might pull the delay trigger. The result may be no deal at all—and further delays.

No doubt many local officials understand this, and also that the local government could (in principle) capture more value through development agreements if CBAs were curtailed. To channel value extraction into public agreements, a city would have to change its regulatory framework in ways that (1) limit the ability of community groups to impose costs on developers who do not sign CBAs, while (2) ensuring that city regulators can impose substantial costs on developers who do not sign development agreements.

However, in California, state law is evolving in ways that make it increasingly difficult for local governments to curtail CBAs while inducing developers to sign rich development agreements. To understand this point requires some further background.

The development agreement emerged after courts held that local governments have essentially unlimited discretion to change the zoning and development regulations applicable to a given site long after the developer has submitted her project application. For example, the California Supreme Court ruled in 1976 that developer who had spent millions of dollars preparing a site and putting in roads and utilities, all with proper permits, had no vested right to complete her project under the rules in place at the time she submitted her application.[38] The only way such a developer could protect herself against possibly calamitous regulatory changes was to bind the city with a development agreement. Or so things stood in 1979, when the California legislature expressly authorized such contracts.[39]

Since then, California has enacted and gradually strengthened two pieces of legislation that put developers on stronger footing. The Housing Element Law requires local governments to periodically revise their general plan and zoning regulations to accommodate regional housing need,[40] and the Housing Accountability Act requires local governments to process zoning- and general-plan-compliant projects under the rules in place at the time the developer's application was deemed complete.[41] The Housing Accountability Act also prevents local governments from denying or reducing the density of a project except on the basis of *objective* standards, with ambiguities resolved in the developer's favor.[42]

Taken together, these laws curtail the obvious value-extraction strategies of (1) establishing a very restrictive zoning baseline, and then approving projects through zoning-map amendments paired with development agreements,[43] or (2) establishing a baseline that allows substantial intensification of use, while frequently and arbitrarily downzoning sites on which project proposals have been submitted (so as to "encourage" prudent developers to negotiate development agreements when they submit their proposals).

So what is a city hoping to extract value through development agreements or other "voluntary," project-specific concessions to do? It can structure the ground rules to give itself broad leeway to *delay* permitting decisions and to impose *discretionary* conditions that do not reduce a project's density. (Conditions that do not reduce density are not subject to the objective-standards requirement of the Housing Accountability Act.) However, if the city retains permitting discretion, then the associated decisions become subject to the California Environmental Quality Act, which means that private groups also have the ability to impose substantial costs and delays by challenging the adequacy of environmental review and mitigation. Moreover, state law gives a project's neighbors the right to a public hearing—if any neighbor asks for it—prior to a discretionary permitting decision.[44] Thus, the very strategy by which California cities nowadays empower themselves to extract "voluntary" concessions notwithstanding the strict limits on mandatory exactions and fees also enables private groups to impose costs on developers.

There is little doubt that supply-constrained cities could create enormous value by enacting a liberal, as-of-right zoning ordinance, with binding time limits for project review including internal appeals.[45] This would free developers from the arbitrary demands of private groups and public regulators alike. Yet none of the devices found in today's value-extraction toolkit would allow a local government to recoup the value it creates by streamlining development permitting.

The development-allowance auction would right this ship, rewarding local governments in direct proportion to the credibility of their commitment to actually permitting the housing which the upzoning nominally allows. (And if a local government wanted to distribute the permit-streamlining surplus to community groups, it could do so with grants, contracts, or even by giving away development allowances to favored groups.)

* * *

In California, the right to auction development allowances would also help to counterbalance significant anti-housing pressures that have arisen from the state's fiscal constitution. As Governor-elect Newsom has recognized, the state's constitutional limitation on property taxes (Proposition 13) has unleashed a destructive competition in which revenue-chasing local governments seek to attract commercial development (for sales- and business-tax revenue) while discouraging housing developments (whose residents may demand more in services than the city receives from them in property taxes).[46]

Consider how things stood for a California city considering a new housing project in 1977 — the year before Proposition 13. The city knew that it had tools, such as special assessments, to pay for costs associated with initiating a project (e.g., enlarging a road), but that it need not worry too much about financing services to the new residents. If it turned out that the locality needed more money, the city council could enact a property tax increase by majority vote. And to the extent the project was successful, the total value of property in the city would increase, yielding additional revenue even if the tax rate remained unchanged.

After Proposition 13, the situation looks quite different. For one, the city cannot increase the property tax rate at all and any other kind of tax increase has also been made much more difficult by Prop. 13 and its progeny. Second, Proposition 13 reduced the average property tax rate by 60% (from 2.5% to 1%). Even if one were to accept that the rates in 1978 were somewhat too high, it seems rather implausible to claim that they were 2.5 times too high to provide the bundle of services residents wanted. Even worse, Proposition 13 also sharply limited the growth of the property tax base: the assessed value of a parcel may increase no more than 2% annually from the time of sale, no matter how much the market value of the property or the city's cost of providing services goes up.

So it's no wonder that California cities nowadays do everything they can either to fence out residential development or to extract what value they can up front, using the available, Rube Goldberg contraptions. By enabling speedy, efficient value extraction, our upzoning-with-auctions model would encourage cities to choose an abundant-housing future.

B. *Would Auctions Be Unlawful?*

In light of previous judicial resistance to explicit trades of rezoning for dollars, one might wonder whether courts would allow local governments to auction development rights created by municipal upzoning in furtherance of state policy. We think the answer is "yes," but we acknowledge two potential lines of attack.

1) An Unconstitutional Taking?

The U.S. Constitution forbids state and local governments from taking private property for public use without just compensation. Elaborating on this idea, the Supreme Court has held that discretionary conditions on development permits are permissible only if proportionate to specific, identified harms or infrastructure needs occasioned by the project.[47]

Under our proposal, the price of development allowances would be roughly proportional to the market value of new housing, rather than to possible harms from particular developments. It might therefore be said that requiring landowners to redeem development allowances as a condition of receiving permits is unconstitutional.

This argument should fail, however, because the constitutional harm-mitigation principle is best understood as governing only *discretionary* conditions on development permits.[48] Under our proposal, the requirement that landowners redeem allowances to build above the development baseline would be *mandatory*, and simple math would determine the number of allowances for a given project.

This is not sophistry. Discretionary conditions are particularly susceptible to favoritism and abuse. The many courts that have complained about extortionate behavior by local governments should cheer our proposal, for as we have seen, ours would actually encourage local governments to curtail their own discretion.

Beyond the fine points of doctrine, might there be some more basic constitutional or normative objection? A generation ago, the economists William Fischel and Robert Nelson argued that local governments should have more or less unfettered discretion to sell rezoning for cash.[49] Their proposals went nowhere. As we previously observed, liberals generally regard the sale of zoning as corrupt, and conservatives see it as extortionate. If local governments could profit from selling development rights, wouldn't they just ban all development everywhere to obtain maximum leverage for negotiating upzones? This would be wasteful, and unfair to landowners who purchased their property and made development plans in reliance on longstanding zoning classifications.

Our model sidesteps the usual zoning-for-sale objections, because it vests authority to approve the rezoning (plus auction) in a different government than the one which profits from it. Local governments could only sell those development rights created by upzonings that advance the state's policies, and with the approval of the state's housing agency. The state policy of promoting dense development near transit would continue to be shaped by environmental, economic, and equity goals, not the prospect of filling state-budget holes with auction revenues (the state wouldn't pocket the revenues). Moreover, state lawmakers could easily allay concerns about "exploitative downzoning" by setting a development baseline that precludes local governments from requiring landowners to redeem allowances if they merely seek to develop at previously-allowed densities. In a legal challenge, the public-profit aspect of our scheme could be defended not as a way of raising revenue, but as a rational means by which the state fosters local-government compliance with its policies.

Nor can it be said that requiring the purchase of development allowances by landowners who want to use the expanded zoning envelope deprives them of anything to which they might reasonably have felt entitled. People who own developable property in expensive urban markets are either lucky legatees or risk-taking participants in the land-development process. Either way, they cannot possibly have a reasonable expectation that the state will relax local density restrictions—precisely because state overrides have been so uncommon and ineffectual in the past.

The airwave spectrum offers an instructive analogy. Congress required TV broadcasters to switch to digital broadcasting in 2009.[50] This freed up valuable, low-frequency portions of the broadcast spectrum, which wireless phone carriers were eager to use. One might suppose that TV stations owned the low-frequency spectrum, because they had previously used it. Yet with the advent of digital broadcasting, they no longer needed it, and Congress saw fit to allocate the freed-up spectrum by auction.[51] Like airwave spectrum that technological change and regulatory mandates have made newly available, the "buildable area" created by pro-housing state interventions in local land use is an essentially new resource. The fortuity of owning land within a state-upzoned area—think of a parcel near transit following enactment of an SB 827-like bill—no more entitles the landowner to the surplus from that upzoning than did the fortuity of using a portion of the airwave spectrum for analog broadcasting entitle TV stations to reap the wireless windfall.

2) State Constitutional Tax Limitations

Many state constitutions constrain taxes and other ways of funding the government. California's requirements for raising revenue are particularly fearsome. Proposition 13 (1978), for example, strictly limits property taxes and imposes a supermajority requirement for most other kinds of taxes.[52] Proposition 218 (1996) limits, among other things, the imposition of "fees" as an "incident of property ownership" or for a "property-related service." Proposition 26 (2010) constrains any government charge for any other kind of public service.[53] A challenge to development-allowance auctions in California grounded on some combination of these restrictions would be likely, but we don't think it would succeed.

For starters, the allowances, though related to property value, are not themselves a tax imposed on property value and therefore would not run afoul of Proposition 13's limitation on property taxes.[54] Further, the allowances are not a fee charged for governmental services and so are not likely to fall under Proposition 218; the auction allowances are not like paying for garbage pickup. One might worry that Prop. 218's notion of an "incident of property ownership" might be interpreted broadly so as to include the allowances. However, the California Supreme Court has already held that this does not extend to voluntary decisions to develop one's property.[55]

Proposition 26, the sweeping catchall, does at first glance restrict "any levy, charge or exaction," yet it specifically excepts "a charge imposed as a condition of property development."[56] Tradeable development allowances fall squarely within this exception. While the analogous proviso in Prop. 218 preserved only "***existing*** laws relating to the imposition of fees or charges as a condition of property development,"[57] Proposition 26's exception has no such temporal limitation. The tradeable development allowance, as a novel sort of "charge imposed as a condition of property development," is therefore on safe ground.

Even if a court were to conclude that "auctioning the upzone" is subject to Proposition 26, that wouldn't kill the idea. Local governments would just have to put their auction programs to a pre-implementation vote of the municipal electorate.

C. *Might Auctions Backfire?*

One might worry that authorizing cities to auction the development rights created by upzoning could affect the development market, or upzoning decisions, in ways that actually undermine the state's goal of producing more housing near transit and job centers. Let us consider several channels through which such "backfires" might be feared to occur.

Initially, one might think that requiring allowances in order to build in the expanded zoning envelope near transit would function as a ***de facto*** tax on development near transit, displacing development to distant locations ("sprawl") where allowances are not required and building is therefore less expensive. This argument mistakenly assumes that the allowance requirement will have no effect on land prices. In fact, in a competitive market, the price of development allowances and land will adjust so that developers earn the same profits at the upzoned sites that they would have earned had no allowances been required.

To see the intuition, imagine a site—say, a commercial warehouse—that has been rezoned for high-density housing. A developer will pay less for this site under a regime in which she must also pay for allowances, than under an otherwise-similar regime in which she could develop the site without redeeming allowances. Yet with or without the development-allowance requirement, competition among developers trying to purchase developable sites will raise the price of the "site plus the right to build X square feet on the site" to the level at which developers earn a normal (risk-adjusted) rate of return. The effect of introducing the development-allowance requirement is just to redistribute what developers pay for the site-plus-right-to-build package between the owner of the site and the owners of development allowances.

Notice also that while developers would pay less for sites under the auctioned-allowances regime than under an otherwise-similar development regime without the allowance requirement, they will still offer ***enough*** to induce site owners to sell, given the site owner's next-best use of the parcel (e.g., continued use as a commercial warehouse). To put this point a bit differently, what developers bid for allowances at the auction will reflect their expectations about what they would have to pay for sites. If developers miscalculate and overpay for allowances at the auction, then the price of allowances on the after-auction market will fall to the point that developers can earn normal profits after buying both the site and the necessary allowances to redevelop it.

The key point is that the auction / transferable-allowance mechanism constantly adjusts the price of the right to build in response to market conditions. If President Trump slaps a tariff on steel, or if labor shortages drive up the wages of construction workers, or if site owners develop sudden emotional attachments to their current uses, the price of allowances will adjust so that developers can continue to buy redevelopable sites, build, and earn normal profits. By contrast, the current value-extraction tools (community-benefit agreements, impact fees, affordable-housing requirements, etc.) do not have this automatic-adjustment feature, and therefore pose a much greater threat to housing development during economic downturns.

* * *

Notwithstanding the salutary, automatic-adjustment feature of the development-allowance mechanism, we do acknowledge that our proposal could delay or retard development in some circumstances. For example, if someone cornered the market in development allowances, the costs and delays associated with haggling over allowances may become quite substantial. This is a reason to design the market carefully and subject it to antitrust controls, but not to dismiss the idea out of hand.

Regulatory arbitrage is another possible concern. A developer who has acquired a prime site might refrain from developing it today if she thinks a future city council may change the rules and let her develop it "for free," without redeeming any allowances. But this is not unique to our proposal. A developer who today confronts stringent impact fees or affordable housing requirements might also delay her project if she thinks a future city council may relax the requirements or grant an exemption.

The "backfire" possibility that most concerns us is that the development-allowance regime may discourage local governments from voluntarily upzoning in circumstances where the upzone is ***not*** reasonably necessary to advance state policy, or so the state agency rules. In such cases, a strategic local government might decide to wait, delaying the upzone until state policy or local circumstances change and allow the new development rights to be sold. This possibility counsels in favor of a very liberal state-approval standard. Perhaps the legislature should declare that all upzoning above median residential density is presumed to be in the statewide interest, outside of priority conservation areas.

Our proposal vests a lot of responsibility in the state housing agency, which may come under pressure from interest groups that favor restrictive housing policies. Indeed, a local government which has received the agency's approval for its upzoning-with-auction plan might lobby the agency to disapprove similar plans submitted by other localities in the same region. Disapproval of those auction plans would make the other local governments less likely to follow through with their upzonings, with the result that development allowances in the already-approved jurisdiction become even more valuable.

While we cannot rule out such perversions, the risks must be weighed against the dangers of the status quo. In high-cost, supply-constrained states such as California, some further inducement is clearly necessary to get local governments to allow enough new housing. The interests that oppose dense new housing at the local level—homeowners and neighborhood groups—are not as well organized at the state level. Business interests, which are well represented in state capitals, have a strong incentive to lobby for pro-housing policies.[58] On balance, we think the risk of the state housing agency being captured by anti-development interests pales in comparison to the dangers of the status quo, in which city council representatives who gum up the development pipeline are rewarded by neighborhood constituents and face little countervailing pressure.[59]

That said, a state policymaker who disagrees with our judgment about relative risks might consider a more limited, targeted version of our proposal, in which the only development rights that cities could auction would be those created by a state statute that directly upzones certain areas where local governments have resisted development.[60] Sen. Weiner's SB 827 is a good example. Because the statute would do the upzoning, the state housing agency would have no occasion to make case-by-case determinations about whether a locally-proposed upzoning further state policy, and so there'd be less risk of "backfire" through capture of the state agency by anti-development interests. On the other hand, this more limited version of our proposal may result in a thinner, less competitive market in development allowances, and some cities might delay voluntary upzoning outside the state-upzoned areas in the hopes of later winning legislative authorization for an auction. It's possible that voluntary-upzoning delays under this regime would turn out to be more serious and substantial than under a regime in which any municipal upzoning is auctionable with the state agency's approval.[61]

IV. Conclusion

The debate launched by SB 827 has brought badly needed attention to the economic and environmental benefits, as well as the political difficulties, of repurposing land near transit stations for high-density housing. This white paper has introduced a new tool—the development rights auction—for addressing those political difficulties. State upzoning bills would probably become easier to enact, and more faithfully implemented, if the state authorized local governments to profit from them by auctioning the newly created development rights.

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ENDNOTES:

[1] Scott Wiener, *My Transit Density Bill (SB 827): Answering Common Questions and Debunking Misinformation*, THE MARKET URBANISM REPORT, Jan. 19, 2018, https://marketurbanismreport.com/transit-density-bill-sb-827-answering-common-questions-debunking-misinformation/.

[2] *See* Conor Dougherty, *California Lawmakers Kill Housing Bill After Fierce Debate*, N.Y. TIMES, Apr. 17, 2018.

[3] https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200SB50

[4] Doug Trum, *State Sen. Palumbo Plans to Introduce a Minimum Housing Density Bill*, THE URBANIST, Oct. 5, 2018, https://www.theurbanist.org/2018/10/05/state-sen-palumbo-plans-to-introduce-a-minimum-housing-density-bill/.

[5] *See generally* Christopher S. Elmendorf, Beyond the Double Veto: Land Use Plans as Preemptive Intergovernmental Contracts 49-52 (November 6, 2018). Available at SSRN: https://ssrn.com/abstract=3256857.

[6] Scott Wiener, *SB 827 Retains an Awful Lot of Local Control and Community Planning*, MEDIUM, Apr. 8, 2018, https://medium.com/@Scott_Wiener/sb-827-retains-an-awful-lot-of-local-control-and-community-planning-b1d111fc1007.

[7] See, *e.g.*, USC Dornsife/L.A. Times California Poll, Oct. 24, 2018, https://dornsife.usc.edu/unruh/past-polls/ (finding that by a 3:1 margin, registered and likely California voters endorsed proposition that "[t]he authority to approve housing developments should remain primarily with cities and counties," over proposition that "[t]he state should have greater authority to approve housing developments than it does now."

[8] For a comparative review of the housing policies of California and other high-cost states, see Elmendorf, *supra* note 5, at 15-39.

[9] *See*, *e.g.*, LEGISLATIVE ANALYST'S OFFICE, CALIFORNIA'S HIGH HOUSING COSTS: CAUSES AND CONSEQUENCES (Mar. 17, 2015), https://lao.ca.gov/reports/2015/finance/housing-costs/housing-costs.pdf.

[10] WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES (2001).

[11] *See*, *e.g.*, Liam Dillon, *California Lawmakers Have Tried for 50 Years to Fix the State's Housing Crisis. Here's Why They've Failed*, L.A. TIMES, June 29, 2017 (quoting Foster City councilman Herb Perez on the city's housing element and mentioning other examples: "What I'm seeing here is an elaborate shell game. Because we're kind of lying. It's the only word I can come up with. We have no intention of actually building the units."). *See also* Paul G. Lewis, *Can State Review of Local Planning Increase Housing Production?*,16 HOUSING POL'Y DEBATE 173 (2005) (finding that local governments with state-approved housing plans produced no more new housing than local governments without state-approved plans); Darrel Ramsey-Musolf, *Evaluating California's Housing Element Law, Housing Equity, and Housing Production (1990–2007)*, 26 HOUSING POL'Y DEBATE 488, 491 (2016) (finding, on basis of more recent data, that local governments with approved housing plans produced more price-restricted housing but less market-rate housing than those without an approved plan).

[12] Margaret F. Brinig & Nicole Stelle Garnett, *A Room of One's Own: Accessory Dwelling Unit Reforms and Local Parochialism*, 45 URB. LAW. 519, 541-67 (2013).

[13] *See* Elmendorf, *supra* note 5, at 52-54.

[14] David Garcia, ADU Update: Early Lessons and Impacts of California's State and Local Policy Changes (Terner Center, UC Berkeley, Dec. 2017), http://ternercenter.berkeley.edu/uploads/ADU_Update_Brief_December_2017_.pdf.

[15] *See* California Air Resources Board, Cap-and-Trade Program, https://www.arb.ca.gov/cc/capandtrade/capandtrade.htm.

[16] *See* Robert C. Ellickson, *Suburban Growth Controls: An Economic and Legal Analysis*, 86 YALE L.J. 385, 418-24 (1977).

[17] There is a particular danger of monopolization of the development-allowance market with the passage of time. After most development allowances for an upzoned area have been redeemed, the remaining allowances for that zone may be concentrated in a very small number of hands. The costs of haggling with these owners over the purchase of development allowances could become a barrier to further development in the zone. One way to limit this risk is to make the allowances time-limited. Another option is to insist on an upzoning buffer (e.g., requiring the local government to upzone for 125% of the targeted amount of housing, rather than 100%, in the expectation that development may become costly once most of the allowances have been redeemed). Still another possibility is to give landowners a legal right to force the sale of development allowances if the number of potential sellers is small.

[18] *See* John J. Costonis, *Development Rights Transfer: An Exploratory Essay*, 83 YALE L.J. 75 (1973).

[19] *See* Roderick M. Hills, Jr. & David Schleicher, *Planning an Affordable City*, 101 IOWA L. REV. 91, 125-27 (2015).

[20] Landowners in a locally designated "sending zone" have no stronger claim to the value created by upzoning somewhere else than does any other member of the polity.

[21] For an in-depth look at development permitting in the San Francisco Bay Area, see Moira O'Neill, Giulia Gualco-Nelson & Eric Biber, Getting It Right: Examining the Local Land Use Entitlement Process in California to Inform Policy and Process (Feb. 2018), https://www.law.berkeley.edu/research/clee/research/land-use/getting-it-right/.

[22] *Id. See also* Edward L. Glaeser & Joseph Gyourko, The Impact of Zoning on Housing Affordability (NBER Working Paper No. 8835, Mar. 2002), https://www.nber.org/papers/w8835.

[23] On housing costs and barriers to production in these cities, see Edward Glaeser & Joseph Gyourko, *The Economic Implications of Housing Supply*, 32 J. ECON. PERSP. 3 (2018); David Schleicher, *City Unplanning*, 122 YALE L.J. 1670, 1675 (2013).

[24] Similar "deemed approval" provisos are found in Massachusetts and Rhode Island statutes authorizing certain affordable-housing projects, and in a California statute authorizing certain projects "as of right" with the territory of local governments that have failed to produce their share of regionally needed housing. *See* Elmendorf, *supra* note 5, at 19-20, 47-48, and sources cited therein.

[25] *See* Glaeser & Gyourko, *supra* note 23.

[26] Keith R. Ihlanfeldt, *The Effect of Land Use Regulation on Housing and Land Prices*, 61 J. URBAN ECON. 420 (2007).

[27] Cal. Gov't Code §§ 65580 et seq.

[28] Cal. Gov't Code § 65883.2; http://www.hcd.ca.gov/community-development/building-blocks/index.shtml.

[29] Cal. Govt Code § 65400.

[30] Of course, the prospect of HCD intervention will also be reflected in the market price of development allowances. But HCD doesn't have tools that allow it to easily override local land use decisions. At best, it can decertify a housing element, but decertification has only a marginal effect on developers' ability to get projects through the permitting gauntlet. (Jurisdictions without a "substantially compliant" housing element cannot use their general plan or zoning code to deny projects in which 20% of the units will be sold or rented at below-market rates. *See* Cal. Govt Code 65589.5(d)(5). However, they have other tools—such as discretionary review, CEQA review, and demolition controls—with which to hamstring such projects.)

[31] Under SB 35, enacted in 2017, projects that comply with local zoning and satisfy certain additional criteria must be approved "as of right" in jurisdictions that have failed to meet their RHNA shares. *See* Cal. Gov't Code § 65913.4(a).

[32] *See*, *e.g.*, Tim Redmond, *Hearing on Wiener Housing Bill Points to the Roots of This Crisis*, 48HILLS, Mar. 12, 2018, https://48hills.org/2018/03/hearing-wiener-housing-bill-points-roots-crisis/.

[33] *Cf.* The California Report, *Local Governments Spend Big to Influence Sacramento*, KQED NEWS, https://www.kqed.org/news/10637900/local-governments-spend-big-to-influence-sacramento ("The money spent on lobbying by government agencies -- cities, counties, school districts, water agencies, even rent control boards across the Golden State -- consistently ranks at or near the top of the heap.")

[34] For a classic treatment of the issue, see Jerold S. Kayden, *Zoning for Dollars: New Rules for an Old Game: Comments on the* Municipal Art Society *and* Nollan *Cases*, 39 WASH. U. J. URB. & CONTEMP. L. 3 (1991).

[35] An exaction is an in-kind transfer from the landowner to the government, imposed as a condition on a development permit. Exactions and analogous monetary fees have been circumscribed by the U.S. Supreme Court's "unconstitutional takings" jurisprudence. *See*, *e.g.*, Koontz v. St. John's River Water Management Dist, 570 U.S. 595 (2013). Many states independently limit exactions and impact fees as a matter of state statutory or constitutional law.

[36] *See* Vicki Been, *Community Benefits: A New Local Government Tool or Another Variation on the Exactions Theme?*, 77 U. CHI. L. REV. 5 (2010); Daniel P. Selmi, *The Contract Transformation in Land Use Regulation*, 63 STAN. L. REV. 591 (2010); Cecily Talbert Barclay, David Callies & Julie Tappendorf, Development by Agreement: A Tool Kit for Land Developers and Local Governments (American Bar Association, Section of State and Local Government Law, 2012).

[37] If the community benefit agreement is an explicit condition of project approval, it would be subject to judicial review for proportionality, see Been, *supra* note **Error! Bookmark not defined.**. It has been argued that nominally private CBAs should be treated like governmental exactions if the government is involved in negotiating the agreement or sufficiently "encourages" the developer's assent, but to date there has been little judicial policing of these agreements.

[38] Avco Community Developers, Inc. v. South Coast Regional Com., 17 Cal. 3d 785 (1976).

[39] Cal. Gov't Code § 65864 *et seq.*