

**How Counties Provide Million Dollar  
Giveaways to Wealthy Developers,  
and  
How Counties Can Reclaim Those  
Dollars for Moderate Income Families**

**By Jeff Hooke  
Maryland Tax Education Foundation  
November 22, 2005**

**How Counties Provide Million Dollar Giveaways to Wealthy Developers, and How Counties Can Reclaim Those Dollars for Moderate-Income Families**

*Background:* Hoping to promote moderate-income housing, many U.S. municipalities and counties provide huge giveaways to real estate developers and corporate landowners. Legislation and zoning amendments increase building heights, density limits and land values, without guaranteeing much more moderate-income housing than would otherwise be the case.

*Example:* Consider the following scenario in Montgomery County, Maryland. Under 2004 regulations, a developer owns land zoned for a 10-story building with up to 160 condominiums. Of the 160 units, 20 (i.e., 12.5%) must be reserved for moderate-income residents(MPDU’s).

The County Council and County Executive approve new regulations for 2005. The building height can now be raised to accommodate 20 extra units, for a total of 180. Of the extra units, 3 units (or 12.5%) are reserved for moderate-income residents.

**Maximum Allowable Condo Units**  
**Montgomery County Example**

	<u>Old Regulations</u>	<u>New Regulations</u>
Full Profit Units	140	157
MPDU’s	<u>20</u>	<u>23</u>
	160	180

Thus, the new regulations allow the developer to build 17 extra “full profit” units (20 total units minus three moderate-income units) on the same parcel of land. How much extra profit does the developer make on these 17 extra units, and what do the three additional MPDU’s cost?

*Extra Profit from Higher Density:* Montgomery County’s Bethesda area has many tall buildings. The average new condo might cost \$300,000 to build (including land), and sell for \$400,000. This 33% profit margin (or \$100,000 gross profit per unit) is consistent with condo developments nationwide. Thus, 17 units increase the developer’s profit by \$1.7 million. (\$100,000 profit per unit times 17 units).

Monthly Cost of Additional Moderate Income Units: The market rental rate for a Bethesda condo is approximately \$2,000 per month. The county requires that the developer rents designated moderate-income units at a discounted rate, dependent on the renter’s ability to pay. Assume \$1,000 per month is the discounted rent. By adhering to the regulations, the developer foregoes \$1,000 per month on an MPDU, or \$3,000 per month for three units. This loss amounts to \$36,000 per year for all three MPDUs.

Long-term Costs: In this paragraph, we calculate the developer’s cost, over the life of the building, to provide discounted housing. A reasonable assumption of the developer’s cost of (a) equity capital is 20%, and (b) debt capital is 8%. The equity/debt ratio of typical development is 25%/75%, resulting in a combined cost of capital of 11% annually, (i.e., (25% x 20%) plus (75% x 8%).

To determine the “present value” to the developer of foregoing \$3,000 per month in rental payments for 20 years, the analysis uses a discount factor of 11% annually. The present value of this lost rental over 20 years is therefore \$287,000.

Determining the Developer Windfall: Subtracting (a) the \$287,000 lost present value from the three MPDU’s from (b) the \$1.7 million in extra profit from the 17 “full profit” condos produces (c) a net profit to the developer of \$1.4 million. In other words, to create \$287,000 in value for moderate-income residents, the new regulations provide the wealthy developer with a \$1.4 million bonanza.

**Calculation of Developer Profits:  
Condo Building in Bethesda, MD,  
Additional Density Exchange for  
Three New MPDU’S**

	(\$ millions)
Extra Profit on 17 New Condos (a)	\$1.7
Lost Rental on 3 New MPDU’S (b)	<u>(0.3)</u>
Net Profit from Additional Density(c)	\$1.4

Suppose the County requires the developer to sell the three MPDUs to moderate-income residents, instead of renting them. At a purchase price discount of \$100,000 per unit (i.e., 25% of the \$400,000 price) the developer still achieves a \$1.4 million windfall. The \$1.7 million extra profit is reduced by the total \$300,000 price discounts.

Actual Evidence of Real Estate Value Increases From Zoning Density Changes: On November 30, 2004, the Montgomery County Council passed legislation permitting greater density as outlined above. To determine the effect of the zoning change, MTEF contracted a national real estate consulting firm, CoStar Group, to provide information on commercial property sales occurring before, and after, the legislation in a portion of the

affected areas. The designated area was the Woodmont Triangle sector in downtown Bethesda. I examined all six commercial transactions taking place 18 months before the legislation. The median price per square foot was \$167, compared to \$420 for the seven “after” sales, taking place from November 30, 2004 to August 31, 2005. Most of the 152% increase (i.e., \$253 per square foot) was attributable to the higher density, which can be transferred from one landowner to another for cash.

The Woodmont Triangle has about 3.1 million square feet of commercial property. Assume half of the property can benefit and the extra density value is \$200 per square foot. The giveaway is thus \$300 million (3.1 million x 50% x \$200).

*Process:* Besides the problem of huge subsidies to wealthy developers, the difficulties with the enabling regulations extend into process. Neither the real estate community nor the local governments offer scientific evidence that demonstrate that developers suffer because of moderate-income housing requirements. For example, the study completed by the Montgomery County Council staff in February 2004 found neither (i) an economic hardship nor (ii) a logical basis for assuming more moderate-income housing with the new regulations. Indeed, land prices for residential, apartment, and condominium uses continue to rise, indicating that the prior MPDU requirements had a negligible impact.

In selected cases, developers satisfy their moderate-income housing obligations by making cash payments to local governments (a “buyout”). These arrangements are appropriate in certain circumstances, but the record shows that Montgomery County, for example, is out negotiated, extracting only 20% of the economic value accruing to the developers.

*Market-Based Solution to Help Moderate Income Families:* To extract the maximum benefits for citizens when dealing with the private sector, many governments turn to market-based solutions. For example, the federal government auctions oil leases and cellular phone spectrum. There is no reason for a county government to approve free density expansions to developers -- worth millions – in exchange for a small amount of value for its poorer citizens.

A fair solution is for a county to auction off density expansion rights to competing landowners either for (a) cash, which then could be applied by a county to a directly-funded housing program; or (b) additional moderate-income units, whereby the auction “winner” is the landowner promising to provide the most moderate-income housing in its development in exchange for the higher density.

In the above example, an auction would generate 80% of the additional profits that previously accrued to the developer, or \$1.1 million in cash. With these extra funds, Montgomery County would have the resources to subsidize an additional 11 rental units for moderate-income families. The market-based solution thus increases moderate-income housing from three units to fourteen units, a gain of 366%.

In Montgomery County, for example, the new regulations cover hundreds of building sites, so the potential benefits accruing to the citizens from a market-based solution are enormous. The same holds true for other communities.

*About the Author*

**Jeffrey C. Hooke** is managing director of Hooke Associates, LLC, an investment bank based in McLean, Virginia. His volunteer work includes being chairman of the Maryland Tax Education Foundation ([www.marylandtaxeducation.org](http://www.marylandtaxeducation.org)). Previously, Hooke was a director of Emerging Markets Partnership (a \$5 billion private equity partnership), a principal investment officer of the World Bank Group, and an investment banker with Lehman Brothers and Schroder Wertheim, respectively, two prominent securities firms based in New York.

Hooke is the author of three books: *The Emerging Markets* (2001), *Security Analysis on Wall Street* (1998), and *M&A: A Practical Guide to Doing the Deal* (1996), published by John Wiley & Sons of New York.