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## **California Policy Options**

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# **CALIFORNIA HOUSING POLICY**

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Why should California, or for that matter any governmental entity, have a housing policy? Public policy is typically designed to address a problem, be it actual or potential. For most real estate professionals and policy analysts the answer to the above question is obvious; they are convinced that California is in the midst of a housing crisis of unprecedented magnitude.<sup>1</sup> Thus, there is much interest in current housing policy and the policy debate over the formulation of new policies.

A crisis is typically viewed as a crucial time, a time when inaction will result in a worsening of the state of affairs. Many of the current housing market conditions (e.g., low rates of affordability of single family dwellings) are not unique to contemporary California. In this chapter we conclude that the symptoms of the “housing crisis” are primarily the result of short-run and long-run economic trends, trends that are unlikely to be affected by state and local governmental policy. As such, governmental policy can only marginally influence, for better or worse, the state of the State’s housing.<sup>2</sup>

The remainder of this chapter will be divided into sections that: (1) describe the long-term demand and supply conditions for housing, and (2) describe the effect of governmental policies on the supply and price of housing.

## **The California Markets for Housing**

To an economist, changes in the market price of an asset (such as housing) are pieces of information that summarize the interactions of the forces of demand and supply. Secular increases in prices imply the demand for the asset (housing) has increased more than supply. It is common knowledge that California home prices have been increasing rapidly for a sustained period of time and they are extraordinarily high at this time compared with many other parts of the U.S. High and rising home prices are viewed as evidence of a “housing crisis,” a crisis that government should address through public policy.

Below we will present evidence that that in many ways the current state of the housing markets is not extraordinary from historical perspective. Public policy prescriptions therefore need to be targeted, rather than general, in nature. In the remainder of this section we explore the state of California housing markets, both for single and multi-family dwellings.

## Single-Family Homes

Figure 1 presents a time series (1968-2003) of median sales prices for California single-family dwellings that shows a mixed picture of nominal price increases. We see that during this thirty-five year period of time the annual median sales price increased from about \$23,000 to more than \$372,000: this rise represents a more than 7 percent compounded annual rate of growth in home values.<sup>3</sup> Figure 2 presents the same series in terms of 2000 dollars, i.e., adjusted for inflation.<sup>4</sup> Here we see the large decline in real values that occurred during the early nineties. The decline was followed by a run-up in value that has coincided with the unprecedented drop in interest rates during the last three years. On the average, real home values increased by approximately 3.1 percent in comparison to the average annual rate of growth in real GDP (3 percent) for the thirty-five year period. As we can see from Figure 2, until the large declines in interest that occurred during 2001-2003, home value increased, on the average, at about the same rate as real GDP (the ex-post real risk free rate of interest).<sup>5</sup> Examining Figure 2 further, we see that the real median sales price of a California home did not return to its 1990 level for 10 years. Thus, the home price increases during this period are not, in and of themselves, indicative of a statewide housing crisis.<sup>6</sup>

An important function of prices is to ration scarce goods. Many people find California a desirable place to live and work. Thus, home prices above national averages are not surprising. However, an indicator of a housing crisis might be an unprecedented low level of housing affordability. A statistic that can be used to measure this concept is an affordability index created by the California Association of Realtors. This index is the fraction of the population that can “afford” (i.e., has sufficient income given market interest rates and typical loan qualification requirements) to purchase a median priced home. Figure 3 presents a time series (1983-2003) of this statistic for California and the United States.

Not surprisingly, given the level of California home prices, the fraction of the population that can afford a median priced house in California is always below that of the U.S. The index for California was substantially below 50 percent for the entire period. In contrast, for the country as a whole, more than 50 percent of the population could afford the median priced house. In addition, for the nation – but not for the State – there was a secular increase in the fraction of the population that can afford a median priced house.

Inspection of Figure 3 reveals that recent levels of affordability in California (about 26%) are not unprecedented for the State. The current rate is below the long-term California average of 31 percent. But during the mid-1980s, the level of affordability was at least as low as it is today.<sup>7</sup> If housing affordability is a problem, these data suggest that it is not a new problem.

High prices and low affordability would be expected to translate into relatively low rates of homeownership. Figure 4 presents a time series of homeownership rates (1960-2000) for the US, California and for Los Angeles County. During this entire period, the homeownership rate for Los Angeles County were below the State’s rate. And the California rate was below the U.S.

rate. What is revealing is that big change in the State’s homeownership relative to the national level occurred between 1960 and 1970, not during the 1980s or 1990s. Again, if the State’s homeownership rate relative to the U.S. rate is a crisis, it has been a long-lived crisis.

“Location, location, location” is a mantra of real estate. California is a large diverse state with large variations in land values and home prices. Figure 5 illustrates this variability. Time series of median sales prices (1984-2003) are presented for the State and for four localities: Los Angeles, San Francisco, Sacramento and the Inland Empire (Riverside and San Bernardino Counties). The first two localities are high priced and the last two are growing low priced areas.

For California as a whole, and for all four of the sub-areas, home values were relatively flat from the late 1980s to the mid-1990s. Afterwards, typical home values increased in response to the decline in interest rates experienced 2001-2003. From Figure 5 we see that there are large differences in sale prices. For example, during 2003, the median sales price of a San Francisco home was more than 225 percent greater than that for the Inland Empire and Sacramento.

Figure 6 presents affordability indexes for the State and the same four regions. Here we see the indexes have varied during 1984-2003. We see substantial drops in affordability starting in 2000 for all regions. But again, levels of affordability in the later years of Figure 6 are not unprecedented.<sup>8</sup> A lack of housing affordability appears to be more a regional rather than a statewide problem. For example, housing affordability is much less of a problem in the Inland Empire and Sacramento. Following Glaeser and Gyourko (2003), these statistics may be more indicative of a poverty problem rather than a housing crisis. Persons with low incomes will have problem in affording many items including housing.

Economists expect increases in market prices to induce increases in supply. There was a rapid increase in housing starts during the 2001-2003. Are current market prices are high enough to provide an incentive to build a “sufficient” number of new homes. On Table 1 we have taken the 2003 median sales price of an existing home (typically less than the price for a new home) for each area and subtracted an estimate of the construction costs for a “typical” 2200 square foot, three bedroom house.<sup>9</sup> The last row is the residual, which would be the payment for land, entitlements and developer profits.

**Table 1: Housing Cost Analysis by Area**

	<b>CA</b>	<b>LA</b>	<b>San Francisco</b>	<b>Sacramento</b>	<b>Inland Empire</b>
<b>Median Sales price</b>	\$372,700	\$354,700	\$558,100	\$247,600	\$220,900
<b>Construction Costs</b>	\$165,000	\$165,000	\$165,000	\$165,000	\$165,000
<b>Residual</b>	\$207,700	\$189,700	\$393,100	\$82,600	\$55,900

While entitlement costs and developer fees are an important contribution to the cost of housing, they are not the primary determinate of the price of new construction. Land costs are the major factor. From this analysis we can see that private production of new housing, albeit expensive, is possible.

Following this line of analysis, Kaplan and McAllister (2002) report a comparison of the cost, for Standard Pacific Homes (a major home builder), of identical three bedroom, 2200 square foot, one built in San Jose and the other built in Dallas or Phoenix. Table 2 presents the costs for the two “representative homes.” Differences in land costs are again a primary determinate of differences in price. For example, eliminating developer fees would have a second-order effect on the price of new housing, about 4 percent for San Jose and 2.5 percent for Phoenix.

**Table 2: Standard Pacific Homes Costs**

	Price	Construction	Developer Fees	Land
<b>San Jose</b>	\$665,000	\$143,000	\$29,000	\$232,000
<b>Phoenix/Dallas</b>	\$198,000	\$100,000	\$5,000	\$29,000

As seen by the recent level of housing starts, it is economically feasible to build houses in California. But at the same time, a relatively large fraction of the population is priced out of the single-family home market in the state’s major metropolitan areas. It is that observation that often leads to the conclusion that there is a housing crisis.

### 1) Multi-Family Housing

Over time, the distribution of income and wealth in California has become more skewed.<sup>10</sup> Given the level of educational attainment and associated income levels, an increasing portion of the population will never be able to afford a single-family dwelling.<sup>11</sup> For these families the supply of multi-family housing (apartments) and rents are keys to their wellbeing.

Ong et. al (2004) constructed a statistic to measure the economic burden associated with renting: the ratio of the median gross annual rent to the 25<sup>th</sup> percentile of the income distribution. The rental cost burden statistic increased from 27 percent in 1960 to 38 percent in 1990. Between 1990 and 2000, the rental burden actually dropped slightly to 37 percent. Stagnant rents implied that new apartment construction was not economically feasible for much of the State. However, while California rents were high by national standards, the burden of renting did not increase during the 1990s.

As noted earlier, increases in asset prices provide incentives for new construction. Figure 7 presents a time series (1990-2003) of the per-unit sales price of “typical” apartment buildings for Los Angeles County, San Diego County, Orange County and the Inland Empire.<sup>12</sup> For each

of the areas, there were large drops in the market value of apartment buildings during the early-to mid-1990s. Since that period, values have increased substantially. But real values are only slightly higher than they were during 1990.

Figure 8 presents the corresponding real (2000 dollars) per-unit prices. Real values declined for all areas during the early 1990s, and did not reach their 1990 level until ten years later. This pattern did not provide an economic environment that was conducive to new construction. Table 3 presents per unit price, by area, for a “typical” apartment unit sold during the first half of 2004.

**Table 3: 2004 Price per unit and Construction Costs**

	<b>Orange County</b>	<b>San Diego</b>	<b>Inland Empire</b>	<b>Los Angeles</b>
<b>Per unit price</b>	\$120,833	\$118,095	\$76,728	\$96,875
<b>Construction costs</b>	\$112,000	\$112,000	\$112,000	\$112,000
<b>Surplus</b>	\$8,833	\$6,095	-\$35,272	-\$15,125

Construction cost of approximately \$112,000 per unit would be entailed in new construction.<sup>13</sup> The economic infeasibility of new construction can be seen from the surplus row (the amount available to cover land cost, entitlements and profits). The surpluses for the Inland Empire and Los Angeles County are negative. This result implies that at typical sales prices, revenues would not even cover the cost of construction. While positive, the surpluses for Orange County and San Diego County are so small that they are unlikely to even cover the cost entitlements. (Per-unit entitlements costs in excess of \$10,000 per unit are typical for these areas). In response to these conditions we only see luxury apartments and condominiums being built. These figures suggest that the only governmental policies that will increase the supply of affordable apartments units in core metropolitan areas are direct or indirect subsidies.

## 2) Housing Policy

Housing policy can have a positive or negative effect on the supply (cost) of housing. Our analysis, to this point, suggests that the major constraint on the supply of housing is the cost and availability of land in major urban areas. The rapid development of the Inland Empire has been primarily driven by two factors: relatively cheap land and a good network of roads. In the Inland Empire jobs have followed increased availability of housing.

Apartment rents are relatively high in the State’s major metropolitan areas, but as we have seen, are not high enough to warrant new construction of “affordable” units. Population growth will place continued upward pressure on rents but rent increases are unlikely to make new construction pencil out. “You can’t get blood out of a stone.”<sup>14</sup> In the remainder of this section we will explore some governmental policies that tend to limit the supply of housing.

### 3) Land Use Restrictions

External benefits and costs has been the traditional rationale for zoning restrictions. For instance, if an auto salvage yard was located in residential neighborhoods, it would be expected to impose large costs on the homeowners. But the same is not true if the yard was located in an industrial area. By establishing exclusionary zoning, cities have attempted to limit the negative effects of non-conforming uses on local property values.

The single-family detached home (R-1) sits at the top of the zoning hierarchy in terms of tight control. R-2, is for two-family residences, R-3 (limited) and R4 (unlimited) are for multiple-family residences. “C” zoning is for commercial property and “M” is for manufacturing.

Associated with each of the zoning designations are a wide range of restrictions on the improvement (building) that is built on the land (e.g., two parking spaces per apartment).<sup>15</sup> Once established, a zoning map will place substantial constraints on the utilization of land, constraints that may result in a sub-optimal use of that land. For instance, the demographic changes that have occurred in Los Angeles County suggest that an increasing fraction of the County’s population is unlikely to ever be able to afford single family home. This fact implies that even if the allocation (fraction) of land to R-1 and R-4 zones within the County was once optimal, it no longer can be given the recent demographic changes.<sup>16</sup>

Changes in zoning that increase land use density are favorable to affordable housing. In the absence of zoning constraints, with well-functioning markets, the highest and best use for some of the marginal (R-1) property would become multi-family dwellings (R-4) and developers would be expected to undertake the transformation. With zoning, however, a multi-family developer would have to obtain a zoning variance, a costly and political process. Such a variance would allow the developer to demolish a single-family residence or residences in order to build a multi-family residence.

For the same reason that there is zoning, neighbors have strong incentives to oppose zoning changes that allow multi-family land use in single-family areas, e.g., R-1 to R-4. Because of the strong economic incentives associated with zoning, many communities (such as Burbank) have in fact tightened restrictions on use of residential plots. This tendency makes it even more difficult to build affordable housing. In addition to such restriction, designation as an historical district can constrain the use of property for new residences, particularly multi-family dwellings.<sup>17</sup>

Growth management controls typically restrict growth at the periphery of a city. Landis, Deng and Reilly (2002) evaluate the effect of such controls on metropolitan growth patterns in California. They report that California cities and counties have more than two dozen programs in place to regulate growth and development. Among the most important are: (1) zoning, (2) housing caps, (3) subdivision regulation, and (4) environmental assessment and review. They also report that the use of the controls by California jurisdictions grew during the 1990s.

Glaeser and Gyourko (2003) provide an analysis of the effect of building restriction on the affordability of housing. Their approach was to undertake a cross-sectional (over cities) statistical analysis of variations in home prices. They concluded that the cost of these restrictions and controls in terms of home prices are large.

#### 4) Development Fees and Exactions

In a post-Proposition 13 world, local governments have been strapped for revenue and in response to budget shortfalls they have increasingly turned to fees and exactions paid by developers as a source of public revenue.<sup>18</sup> In practice there are great variations between governmental entities and projects in the size of these fees and exactions. Dresch and Sheffrin (1997) studied Contra Costa County from 1992-1996 to estimate the effect of these costs on housing prices. The authors found that such developer fees ranged between 4.7 and 8.9 percent of the sales price. The costs ranged from approximately 7 to 20 percent of the sales price of a new single family dwelling. While the data used for this study is dated, it is consistent with the estimates described earlier for the construction of a home in San Jose by Standard Pacific Homes.

Without question, fees and exactions substantially contribute to the costs of new construction – particularly in the periphery of major metropolitan areas. To the extent that these costs actually reflect the costs of producing new housing, they are economically efficient and do not unreasonably burden real estate development. But to the extent they are intended to restrict development beyond what the actual costs would suggest, they lead to inefficient land use.

#### 5) Prevailing Wage Legislation

The Davis-Bacon Act requires that all federal government contracts for the construction or repair of public buildings or public works whose value exceeds \$2,000 pay at least the local “prevailing wage.”<sup>19</sup> Dunn, Quigley and Rosenthal (2003) concluded that “in practice, prevailing wages are union wage rates.” The Act has required that low-income housing sponsored by agencies of the federal government pay “prevailing wages.”

Since 1931, California – as do many other states – has had its own version of a prevailing wage law. In 2001, the State’s law was expanded to include housing subsidized with public funds and some private construction projects. Labor costs account for a substantial fraction of the cost of construction. Since union wages are typically at the top of the scale, prevailing wage legislation would be expected to increase the cost of affordable housing that is covered by the act (SB 975).

Dunn, Quigley and Rosenthal (2003) undertook an econometric investigation of the effect of the prevailing-wage requirement on the cost of low-income housing. They concluded that the Act increased the cost of construction of covered housing between 10 and 20 percent.<sup>20</sup> Thus, the Act decreases the supply of housing for low- and moderate-income households.

#### 6) Construction-Defect Litigation



As noted above, changing California demography implies a substantial increase in the demand for multi-family housing, either rental or in the form of condominiums. By economizing on an expensive resource, land, these types of developments can provide housing at a lower cost. An advantage of condominiums is that they provide a sense of ownership that is an important part of the “American dream.”

Kroll et.al. (2002) analyzed the impact of construction-defect litigation on condominium development. The authors concluded that California is more prone to construction-defect litigation than other states and that the State’s legal environment tends to encourage more lawsuits. For example, California homeowners’ have ten years from the day of construction to sue over defects. In addition, California applies a strict-liability standard. A strict standard and a propensity to litigate result in larger insurance costs in California and reluctance on the part of developers to undertake such projects.

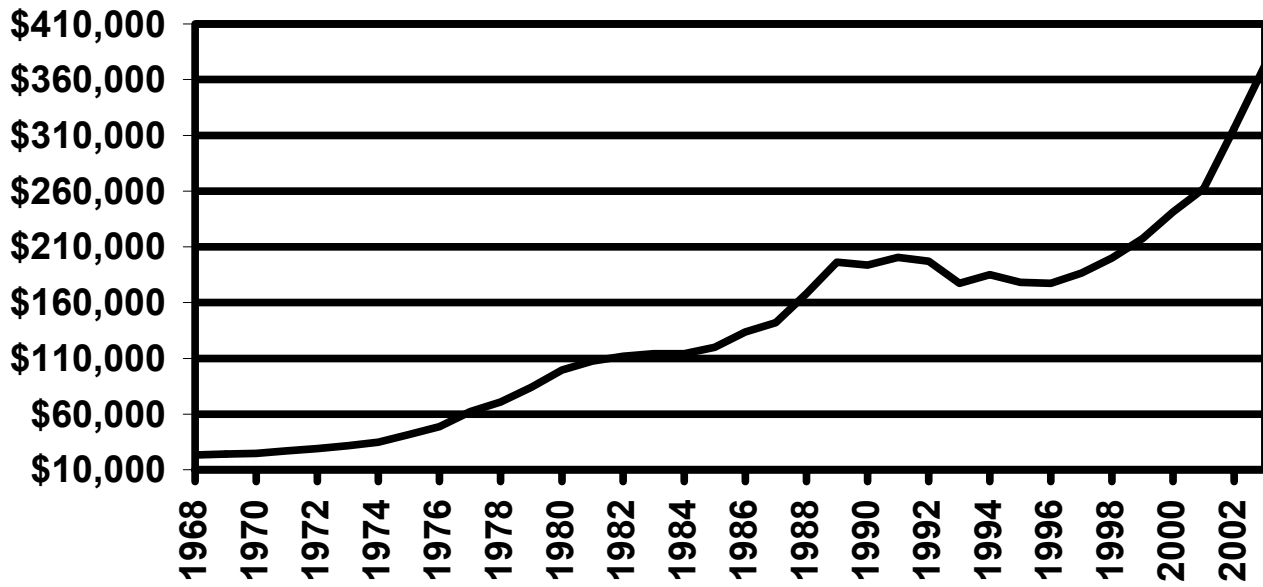
#### Conclusion

In this chapter we have investigated the state of California's housing. Because many people find California a desirable place to live and work, it is not surprising that the State’s home prices are above national averages. Our investigation suggests that if there is a housing crisis, it is has been a feature of California's real estate market for decades. An important function of prices is to ration scarce goods. The State has been, and continues to be, a magnet for internal immigration and foreign immigration. Consequently, the supply of affordable housing is an important policy issue for California.

However, our analysis shows that the cost of land is the primary factor responsible for the high price of California housing. Previous research convincingly demonstrated that the scarcity of land is not the primary driving force for high land prices. Rather, land scarcity results from public policy as reflected in land use restrictions. While these restrictions may serve an important public purpose, their burden falls disproportionately upon the supply of affordable housing. In addition to land use restrictions, the evidence suggests that the state’s prevailing-wage legislation substantially increase the construction cost, and therefore decreases the supply of, low-income housing.

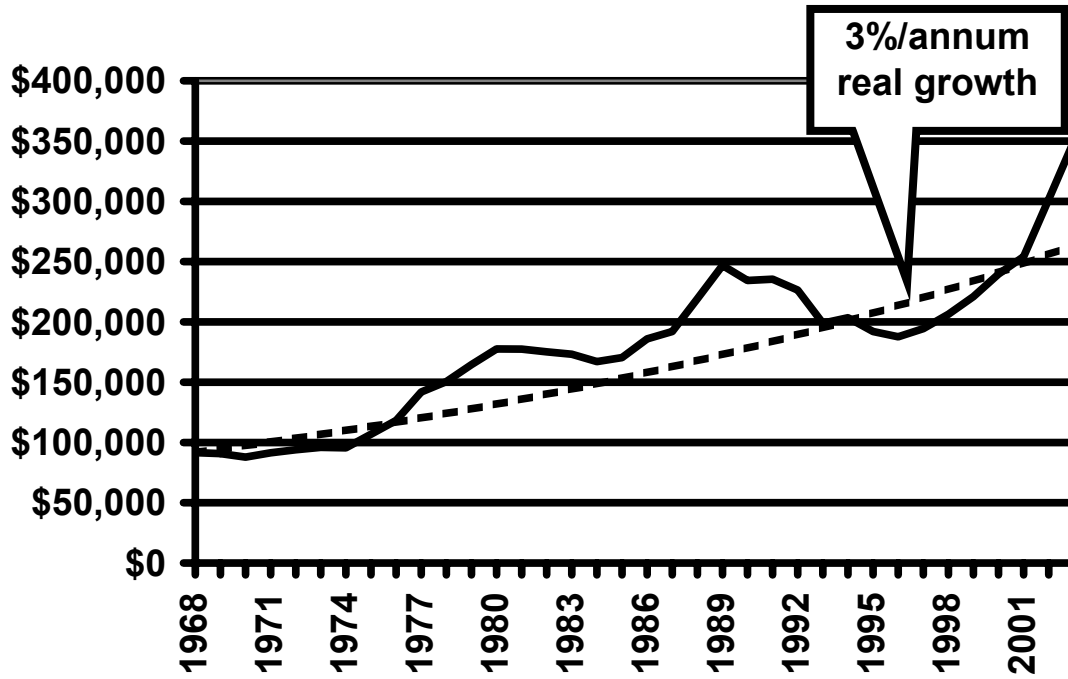
In a time of fiscal constraints, neither California nor the federal government are likely to have sufficient resources to produce housing for all families who would like to live in the State’s major metropolitan areas at “affordable” home prices and rents. We contend that only though less-stringent land use policies, particularly in urban areas, can the housing problems associated with population growth be ameliorated.

**Figure 1: California Median Sales Price  
(1968-2003)**



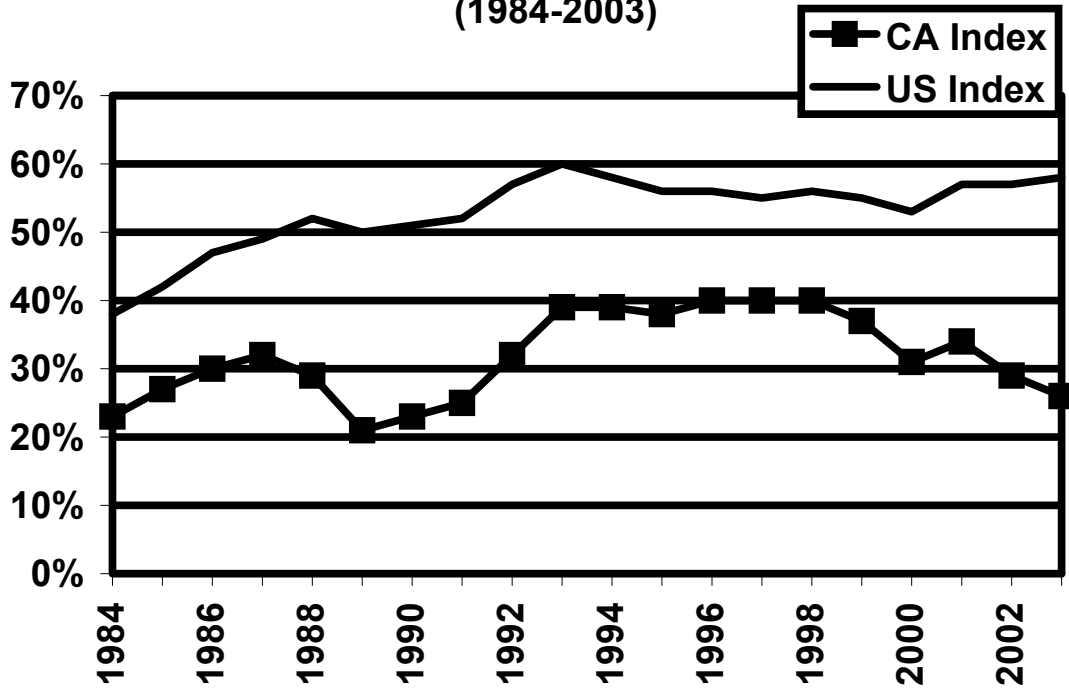
Source: California Association of Realtors

**Figure 2: California  
Inflation Adjusted Median Sales Price (2000\$),  
1968-2004Q2**



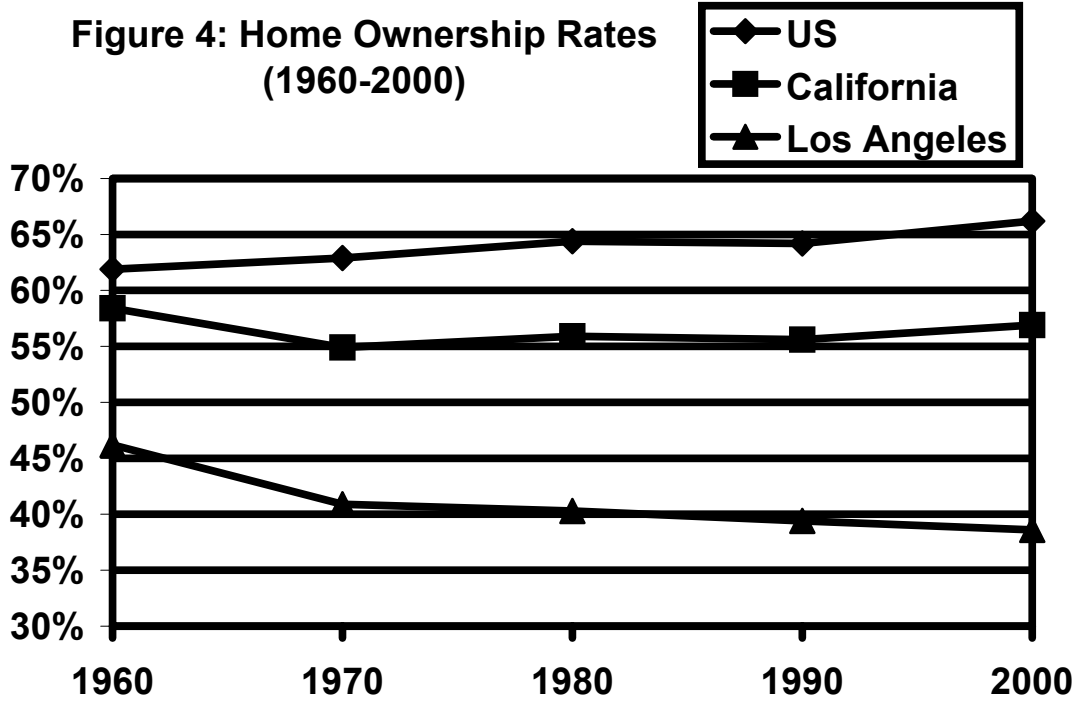
Source: California Association of Realtors

**Figure 3: Index of Affordability  
(1984-2003)**



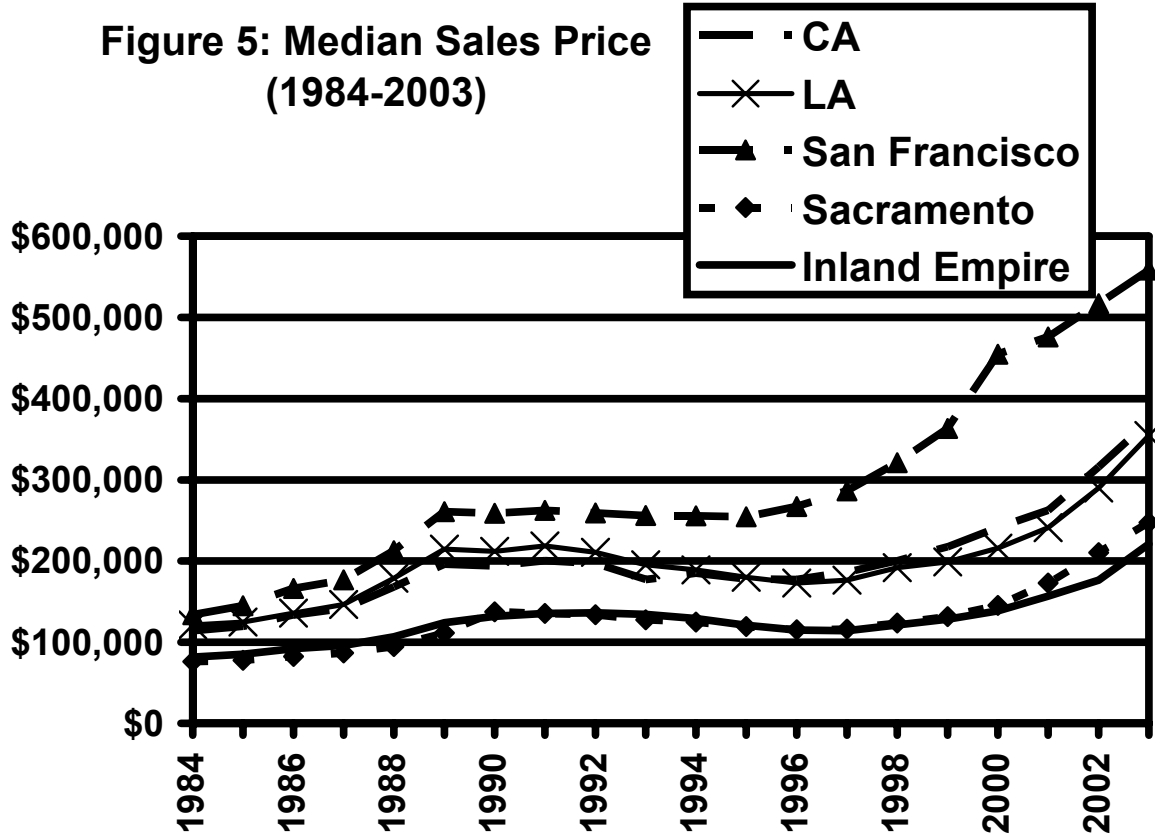
Source: California Association of Realtors

**Figure 4: Home Ownership Rates  
(1960-2000)**



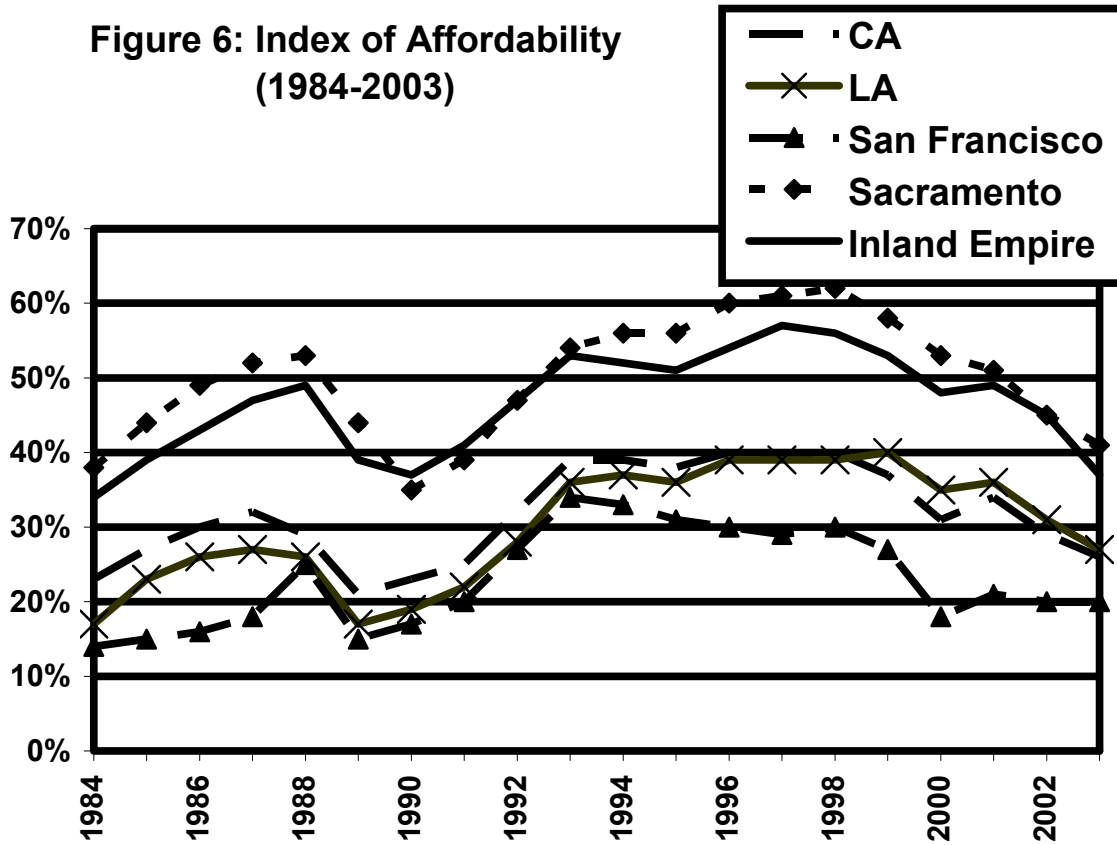
Source: U.S. Bureau of the Census

**Figure 5: Median Sales Price  
(1984-2003)**



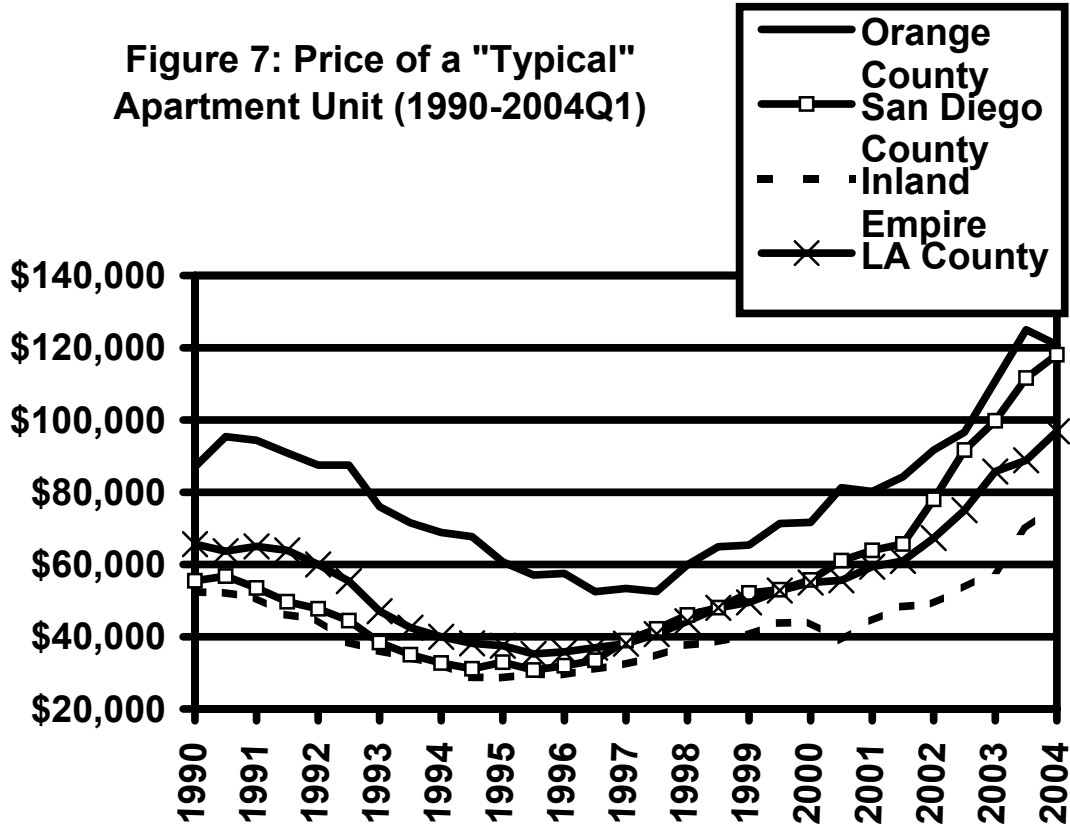
Source: California Association of Realtors

**Figure 6: Index of Affordability  
(1984-2003)**



Source: California Association of Realtors

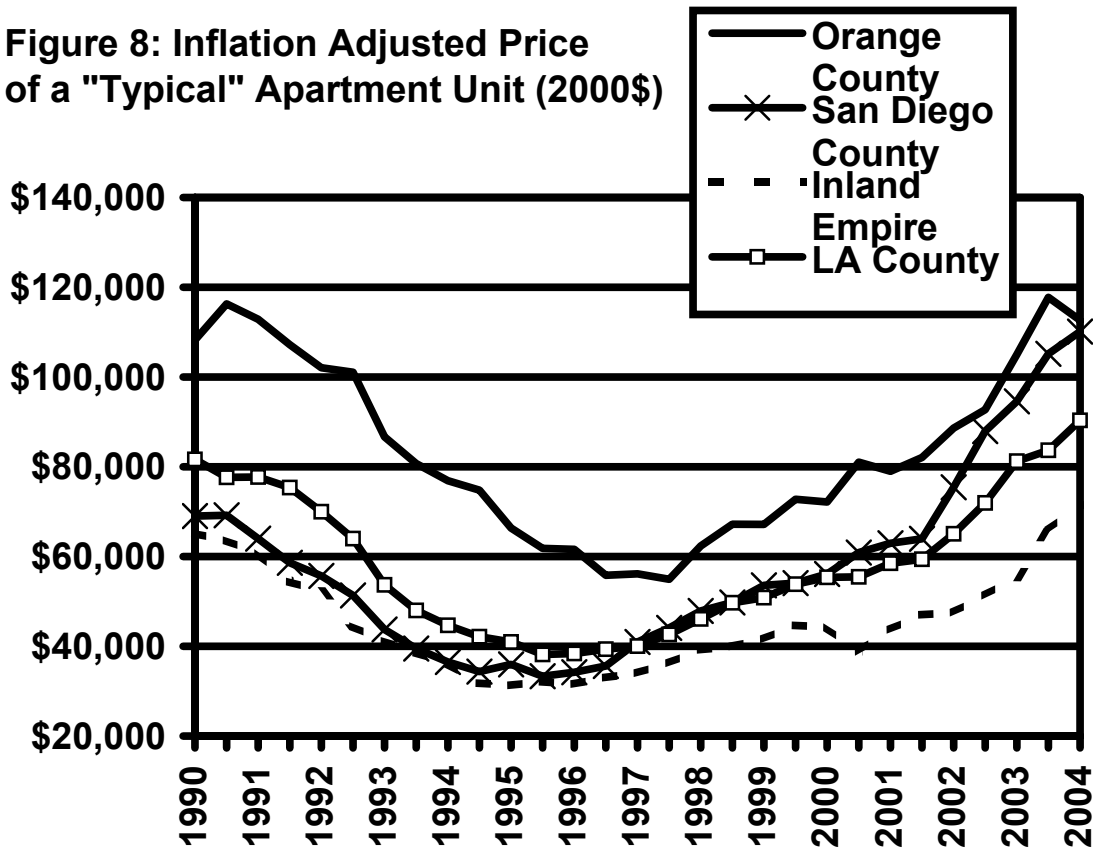
Figure 7: Price of a "Typical" Apartment Unit (1990-2004Q1)



Source: CoStar.com and Ziman Center



Figure 8: Inflation Adjusted Price of a "Typical" Apartment Unit (2000\$)



Source: CoStar.com and Ziman Center

## Endnotes

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<sup>1</sup> For example, California Budget Project (2002). “Locked out 2002: California’s Affordable Housing Crisis Continues.” Ong *et al* (2004) present an insightful analysis of trends that have affected the Southern California housing markets. While their analysis is for Southern California, most of their observations and conclusions apply to the State as a whole.

<sup>2</sup> Glaeser and Gyourko (2003) makes the important distinction between high housing prices and poverty, and conclude that policies designed to lower housing prices may not be the way to ameliorate poverty.

<sup>3</sup> A weakness associated with using median sales price as a measure of market conditions is that the composition of sales is not constant over time and may not be independent of the change in market values.

<sup>4</sup> The nominal price was adjusted by the GDP deflator with year 2000 as a base.

<sup>5</sup> For most families their home is their most important investment. The levered purchase of a home is effectively the purchase of a portfolio comprised of the home and a mortgage loan. The home portion of the portfolio provides a return in terms of housing services and capital gains that is independent of the level of leverage used to finance the purchase.

<sup>6</sup> In terms of a simple present value model of asset price determination, the decrease in long term interest rates that occurred would be consistent with a more than 40 percent increase in property values.

<sup>7</sup> In terms of affordability, decreases in interest rates are a two-edged sword. The lower carrying costs of a mortgage loan of a given size increase affordability, but result in market price increases that hurt affordability.

<sup>8</sup> Note that the decline in the affordability index for the Inland Empire and Sacramento are likely to have been substantially influenced by a change in composition of homes sold. For example, both areas have experienced a building boom (for Sacramento approximately one third of the homes sold during 2003 were new construction).

<sup>9</sup> Although there are substantial difference in construction cost between areas, a flat \$75 per square foot was used for this calculation.

<sup>10</sup> Legislative Analyst Office (2000). “California’s Changing Income Distribution.”

<sup>11</sup> Ong *et al* (2004) compares the US and CA homeownership rates by income quartile for 1970 and 2000. As would be expected, the rate – for both the U.S. and California – increase with income. But the differences between the rates for lower quartiles are approximately what they were during the 1970s.

<sup>12</sup> “Typical” is defined as the median characteristics (e.g., size) for all apartment buildings in the areas.

<sup>13</sup> This estimate is derived from a construction cost calculator provided by the *Building Journal*.

<sup>14</sup> Rent subsidies or housing vouchers could enable lower income families to compete for rental housing. Glaeser and Gyourko (2003) argue that if housing does not cost substantially more than construction costs, policies that subsidize construction may be ill-advised.

<sup>15</sup> Zoning specifications that place burdens on the supply of affordable housing include (1) lot size requirements, (2) building size requirements, (3) frontage requirements, and (4) parking requirements.

<sup>16</sup> Optimality in terms of land use involves taking into consideration the costs and benefits (externalities) of the owner’s land use decisions on other property owners. With quantity restriction it is almost impossible to do so.

<sup>17</sup> See [http://www.ci.glendale.ca.us/gmc/Zoning\\_Code/Chapter30-25.pdf](http://www.ci.glendale.ca.us/gmc/Zoning_Code/Chapter30-25.pdf) for an example of a city’s (Glendale) statute for designation as a historic district or property.

<sup>18</sup> Exactions are a contribution or payment required as precondition for receiving a development permit. An example would be requiring the dedication of land for parks or other public facilities. Proposition 13 was a voter-initiative passed in the late 1970s that substantially reduced and constrained property taxes.

<sup>19</sup> A description of the Act and the determination of the “prevailing wage” is available at <http://www.dol.gov/dol/compliance/comp-dbra.htm>.

<sup>20</sup> Note again that the construction cost is only one element of the price of a building. Land costs are the major component.