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The Housing Crisis in California

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I

"Most people in California enjoy the housing shortage; very few are suffering from it." These words, from a high-ranking executive of one of the largest savings and loan associations in California, reveal the high degree of confusion and the narrowness of perspective which color our perceptions about housing problems in the state today. The purpose of this paper is to clarify the nature of the "housing crisis" in California and to discuss some of the policy options for the 1980s.

The precise dimensions of the current housing shortage are the subject of much dispute. On the one hand, we face a genuine shortage in the "classical" sense of the term. Vacancy rates are at all-time lows. Production is barely keeping up with demand. But housing analysts throughout the state disagree as to whether we will be able to meet expected increases in demand over the next five years. The Department of Housing and Community Development has estimated that we need approximately 290,000 new and rehabilitated units annually between 1980 and 1985. The most recent update of HCD's State Housing Plan forecasts that production will reach no higher than 250,000 units annually during these years. The California Department of Finance is more optimistic. Assuming much lower rates of replacement and no rehabilitation, the Department of Finance has forecasted a demand for 228,000 new units annually over the same period. DOF's projections on the supply side show only one year in which production falls short of demand.

Although HCD's figures are on the high side, they present a far more accurate

picture of the housing shortage which looms before us than the estimates from the Department of Finance do. Annual rates of production are now below 150,000 units and are not likely to climb above the 200,000 level until late 1981. That means that we will be entering the decade with a sizeable housing deficit which is likely to grow during the next few years.

The levels of production between now and 1985 will depend on the "tightness" or "ease" of Federal monetary policy, and the competition for credit between housing, the corporate sector, and the Federal Government. On the one hand, the shift in Federal Reserve Board policy toward greater reliance on the manipulation of monetary aggregates to control the rate of inflation in the economy means that interest rates will be subject to greater fluctuations relative to swings in the level of loan demand. At the same time, we should expect interest rates to ratchet upwards as a result of increased competition for funds in capital markets. In Fiscal 1981 defense spending is scheduled to grow by eight percent in real terms. Boosts in military expenditures of this magnitude will invariably lead to an expansion of both corporate and Federal government borrowing. We should not be too surprised, then, if Washington and the corporate sector crowd housing out of the capital markets in 1981-82. If this proves true, residential construction is likely to make a poor showing over the foreseeable future.

Desegmentation of mortgage-lending institutions within the national capital market system will help to keep mortgage rates high during the next decade and depress production. Until recently, a variety of portfolio restrictions and deposit-rate controls gave savings and loan institutions cheap money

which could only be invested in residential mortgages. The Depository Institution Deregulation and Monetary Control Act of 1980 allowed S&Ls to undertake major diversification of their portfolios for the first time. Under the 1980 Act, S&Ls can now invest up to twenty percent of their assets in commercial loans, whereas previously, only three percent were placed in such loans. Deregulation will improve the ability of the thrifts to compete in capital markets, but it may also lead to a reduction in the supply of mortgage funds at a time when the demand is at an all-time high, and ensure that mortgage rates remain at double-digit levels for the rest of the decade. The era of cheap and abundant mortgage money is over.

In California these macroeconomic and institutional constraints on housing production will be painfully felt in the West because of the unusually strong demand for housing here. Some attribute this surge in demand primarily to the "baby boom" generation piling into the housing market, and believe that the resulting shortage is temporary, for the situation is bound to improve by the late 1980s when the "baby bust" will hit. But this view ignores the impact of increasing net migration into California, which now stands at close to 230,000 persons annually. The energy and economic problems of the Frost-belt will probably continue to generate migrants to our sunny state. It is also likely that immigration from Mexico, Central America, and Asia will increase over the next decade and perhaps equal the baby boom as a major source of new households in California. If net migration to California continues to rise, then we can expect a large and growing adult population in the future despite the "baby bust." The implications of this are clear: housing will be in scarce supply in California for much of the rest of the century.

We also face a shortage of housing in another sense. California is unable to produce enough housing which is affordable according to conventional middle-class standards. The escalating price of single-family housing is outstripping the ability of many first-time buyers to pay. In response to this dilemma, state-licensed savings associations have raised the "low-end" ceiling on the house-payment-to-income ratio for loan

qualification from twenty-five percent to thirty-three percent, and the "high-end" ceiling from thirty-three percent to forty percent. But these are maximum ratios. The distributions themselves do not portray as startling a picture. A recent Walker and Lee survey of new homebuyers in California found that the average payment-to-income ratio in 1979 was 26.1 percent, up from 21.5 percent in 1975. This may be high, but not outrageous.

But social change has distorted the meaning of this conventional measure of housing-expense burden. Three-fourths of today's homebuyers are two-earner households. For this type of household, a twenty-six percent payment-to-income ratio means that more than twice as many work hours per household are required to cover housing costs today as were necessary a decade ago for the more traditional one-earner household. The rise of the two-earner household itself has simply masked a major shift in relative prices which has reduced the real incomes of a large proportion of middle-income homebuyers.

This imbalance between prices and incomes is probably more pervasive than is indicated by measuring the increasing financial burdens of today's homebuyers. A more suggestive measure of affordability might be the number of people who cannot purchase the houses they currently own. It is not unusual to hear homeowners remark with a curious combination of despair and relief, "I couldn't buy my own home today if I had to." These people are potentially priced out of the market. Despite large equities which have ballooned through inflation, such households cannot trade up unless their incomes rise dramatically, or the prices of their homes increase faster than the average price of all housing.

For rental housing, the affordability problem is even worse. Construction costs have been rising faster than rents for almost six years. It now costs close to \$70,000 to build a no-frills, one-bedroom apartment in a three-story wood-frame structure. (This figure includes hard costs, soft costs, fees, land, and financing, but no profit.) To make that unit feasible as an investment today would require a rent of at least \$800 per month. Assuming a twenty-five percent

rent-income ratio means that only a household making \$36,000 a year could afford to rent that unit. Given the current high level of construction costs and interest rates, as well as the tax subsidies that a household earning this much can obtain through owner-occupancy, the developer will build the unit as a condominium instead of a rental apartment. Existing rent levels and renters' incomes, by contrast, can only support a gross construction cost for the same unit of about \$40,000 per unit.

This gap between capitalized rents and construction costs has brought a virtual halt to rental apartment construction. The L.A. Times 1979 Southern California Builders Survey showed that seventy-eight percent of all structures with two units or more produced in the last year were condominiums. The rest were subsidized rental housing projects (primarily elderly and a small amount of market-rate rental in the Central Valley and in San Diego.

The gap between rent levels and construction costs in the rental sector is an object of such great concern because it comes at a time when California is undergoing a tremendous growth in the number of new households. The ageing of the baby-boom generation, along with a vigorous trend in immigration (both legal and illegal), implies a substantial increase in the potential number of renter households. Because of the perverse economics of new construction today, new production of rental apartments is negligible. The outcome is a strong upward pressure on rents and widespread speculation in apartment buildings, tempered in some communities only by the imposition of rent stabilization laws.

At the same time that new construction of apartment buildings has slowed to a trickle, condominium conversions are shrinking the supply at the middle and upper ends of the rental market. Homeownership prices have kept pace with construction costs, thus creating a substantial spread between capitalized rents and home prices. This gap has produced an arbitrage situation for developers who can convert rental units to condominiums and thereby capture an enormous capital gain. In San Francisco, for example, it is not unusual to find buildings which sell for \$50,000 per unit as rental

apartments but will fetch as much as \$135,000 per unit if sold as converted condos.

This disequilibrium in the housing market is rapidly becoming a major political issue, because escalating prices are not generating a burst of new production to eliminate excess demand. Supply is expanding very slowly while prices keep rising. The explanation for this dilemma can be found in *structural* constraints which both inhibit production and boost its cost. By "structural," I refer to legal, political, or institutional limits on the utilization of the major inputs in housing production—land, labor, capital, infrastructure, and public services. Structural constraints prevent builders from adding to supply in response to increases in the demand price. The market reacts to increases in the level of demand by price adjustments only—quantity adjustments are strictly subject to these nonmarket factors.

Alleviating the housing shortage requires that we clearly identify and analyze these structural constraints and that, based on such an analysis, we then seek to modify them. The effort to do this will be politically problematic and fraught with innumerable obstacles. For one thing, many of today's structural constraints on supply are not temporary like those of the 1940s, when the country last experienced a major housing shortage. At that time, the pent-up demand from the war period exceeded the production capacity of the housing sector. In 1946, the Truman Administration began lifting the rationing and allocation controls which had channeled the flow of labor and capital into the war effort. Those controls affecting home construction were removed first. Wage and price controls were also eliminated. Prices shot up. War-time bottlenecks in materials completely disappeared by 1948, and production boomed. Between 1946 and 1948, private residential construction accounted for about two-thirds of the increase in total private investment.

The boom was helped along by Federal Reserve credit policies which kept interest rates low. Federal and state government also expressed their commitment to improving housing conditions and encouraging new residential construction by providing subsidies for highway, school, and sewer develop-

ment. Support for such measures throughout the country was unanimous. Inflation was not so much a concern to policy makers as avoidance of depressions. Both Washington and Sacramento feared a return of idle factories, mass unemployment, and widespread real-estate foreclosures. Stimulation of the demand for housing and related goods and services would—many government economists argued at the time—generate an expanding market for the enormous productive capacity of the nation's plant and labor force.

The solution to the current shortage similarly requires modification of structural constraints on the production of housing. However, the character of these constraints has changed. In the first place, a political consensus favoring increased production does not exist in California today. Those who are concerned about the nation's declining industrial base consider housing to be an unproductive form of investment which deserves a low priority among the country's needs. At the local level the consensus favoring increased new housing production is also missing. Well-housed residents protest at any suggestion of new residential development in their immediate neighborhoods and often in the broader community. Some residents complain about fiscal impacts of new development, while others are concerned about preserving views and shrubbery. Whatever may be their motivation, a large constituency exists throughout California which opposes new housing development.

In this sense, it is not shelter itself that is so difficult to produce, but neighborhoods and residential environments. Housing is not simply shelter, but rather a complex commodity. It is a bundle of goods and services. Housing includes residential services (street repair, security, utilities, etc.), a physical and social neighborhood environment, and a location with accessibility to work, shopping and recreation facilities. To develop housing means to develop neighborhood environments and to build more infrastructure and to expand the supply of public services.

The housing shortage must be thought of in this larger context. The problem we face is not just one of our inability to pro-

duce enough shelter, but a diminished capacity to generate attractive neighborhood environments and the full gamut of public and private services which make up the housing package. The marginal costs of producing more public services and adding to the stock of infrastructure has risen at the same time that the fiscal capacity of government to pay has diminished. To expand the supply of housing and to lower its cost therefore will require not only changes in credit policy and the development of new types of subsidy, but also substantial innovations in land-use regulation and public finance.

II

There are three structural constraints on the supply of housing today: the high cost of mortgage credit, restrictive land-use regulations, and a disorganized system of public finance. Let us look at each briefly.

Mortgage Finance

In the past public intervention in the housing finance area has addressed the objective of providing an adequate quantity of mortgage finance rather than reducing its cost. This policy made perfect sense in an era of stable prices and rising real incomes. In the future housing finance policy will change on the score. The change must come in part because high interest rates are likely to be a permanent part of our future, and also because housing policy in the United States will still be committed to the principle of home ownership. The new households forming today are unlikely to give up their desire for ownership; moreover, given the social benefits of ownership, there is little justification for a shift away from the policy of keeping large parts of the population inflation—hedged through homeownership since this helps minimize some of the worst impacts of rampant inflation.

The emergence of the tax-exempt mortgage revenue bond represents a first step towards the general subsidization of residential mortgage credit. The Federal tax-exemption on the interest income generated by these securities translates into below market mortgage rates. This financial instrument has been used for many years by

State Housing Finance agencies to build low-moderate income housing. More recently, both states and municipalities have been issuing these revenue bonds for purchase and rehabilitation of existing single-family homes, especially in central cities and older suburban communities.

Although Congress plans to restrict the use of these new financial instrument and ration the volume of issues, the potential demand for these subsidized mortgages is immense. According to the Congressional Budget Office, \$7.5 billion of tax-exempt mortgage revenue bonds were issued in 1978—16.2 percent of the total \$46.2 billion state and local government bonds floated that year. During the first four months of 1979, housing bonds increased their share to forty percent of the tax-exempt market. The U.S. Treasury Department has projected that by 1984—assuming no regulation—ten percent or more of all single-family residential mortgage originations would be funded by tax-exempt borrowings.

In the future, Congress will require more of these mortgages funds to be used so as to directly benefit low-income households. State and local governments should also consider ways of allocating more tax-exempt mortgage funds for new construction, physical conversions, or any development which adds new units to the supply to meet the great bulge of demand at the moderate and middle-price ranges. The shortage of supply in these submarkets is increasing the competitive pressures for the low-priced marginal units which in a "normal" market are hard to sell and are typically part of the low-income housing stock. In many California cities they are rapidly filtering up to higher-income households.

Of course, pension funds represent another source of mortgage funds. In the future pension funds may require higher returns in order to pay out benefits which keep pace with the rate of inflation. This should make variable rate mortgages look relatively good in relation to stocks, the long-run yield of which has not kept pace with inflation and has remained below that available on mortgages with double-digit interest rates. Despite much talk about "tapping" pension funds as a source of

long-term housing credit, California has made no serious effort in this direction. Currently, only the State Teachers Retirement System puts some of their funds into housing; but this represents only fifteen percent of their assets, of which practically all goes for the purchase of conventional and GNMA pass-throughs. Much more needs to be done in this area.

Another approach might be to establish mandatory housing finance systems as other countries have done. These could be funded either by mandatory employer contributions or employee payroll deductions. In the latter case, employees would make annual contributions to a tax-sheltered annuity fund. Such an arrangement would allow for a return of between six to eight percent on the fund and translate into relatively low-cost mortgage loans. Such funds could be organized by corporations or by groups of small firms. They could make loans to their employees first, and then to other individuals second. In many ways, this type of financial intermediation would represent a return to the mutual subscription fund—the model for the early savings and loan associations in the nineteenth century.

Though California savings and loan associations have been experimenting with alternative mortgage instruments in recent years, they have given little consideration to the Price Level Adjusted Mortgage (PLAM) which can potentially do more to promote affordable housing than any other innovation in housing finance. The PLAM has been used in Brazil and Sweden to protect the value of mortgage capital and to provide affordable housing. Because the contract rate on a PLAM is set at the real rate of interest, payments start out much lower than on the more common graduated payment mortgage. With this type of mortgage, the principal value of the loan is adjusted each year by a "monetary correction factor." This factor is usually based on some official price-index or a wage rate-index. The loans can be structured to amortize over the contract term with most of the principal being paid off toward the end of the life of the mortgage. While S & Ls might not wish to adopt this type of mortgage because of the enormous accounting problems be involved, the PLAM would however be an ideal mortgage instrument for

pension funds, for whom it would provide protection from inflation in a way which corporate stocks and bonds could never do.

Land Use Policy

California cannot provide for its housing needs unless land-use controls become less restrictive and more mixed-use development incorporating housing is encouraged.

Up until now, the environmentalists have posed the no-growth problem in terms of a conflict between "greedy" developers who want to despoil the environment, and the public at large who want clean air and open space. As the housing shortage worsens, the issue will be recast in terms of competing publics: those who "got there first"—existing residents—and those who are arriving later only to find the gates to the community closed. As the conflict over land-use policy becomes more clearly one between competing publics, the entire land-use policy question must be redefined in terms of the broader social responsibility of local governments to pursue objectives beyond the needs of their existing residents. This implies a much different policy framework for local government and a rejection of the home-rule principle.

Reform of suburban zoning controls and density restrictions is essential if we are to make any progress in reducing the housing shortage between now and 1985. During the latter half of the seventies developers built large homes in low-density environments for second and third-time buyers partly because of restrictive zoning policies, but also because ballooning equities and low interest rates made this particular market the most profitable one around at the time. It is now drying up partly because of high interest rates and soaring construction costs, and partly because the prospect of higher assessments under Proposition 13 discourages trading up.

Although it is unclear to what extent growth-management policies have been the primary cause of the very rapid increase in land prices we have experienced over the past couple of years, increasing land rents will inevitably force us to build housing at higher densities in the future. Unfortunately, most citizens—and quite a few

urban planners—mistakenly associate high-density residential development with crime, poverty, disease, and a whole variety of human perversities. Although the planners can be re-educated on this score, the public at large represents a much greater challenge. The deep-seated bias against high density in our culture goes back to the middle-class revolt against the terrible social conditions which prevailed in large nineteenth-century cities during the industrial revolution. At that time we did not have the building technologies or the design solutions to make high-density living pleasant and attractive. Most urbanists, including the tenement-house reformers themselves, advocated single-family dwellings on cheap suburban land as a solution to the substandard housing and urban slums of nineteenth-century cities. What was a movement in the first quarter of the twentieth century became a policy in the second under the FHA and VA programs in the suburbs.

Today we have the technical construction and design capacity to create comfortable, attractive high-density residential environments without resorting to high-rise. Popular attitudes about density, however, remain the major obstacle. Enhancing the status value of small cars may turn out to be a much easier task than making high-density housing more socially acceptable. In the case of the automobile, economics alone will convince the average driver, who changes cars anyway every three to four years. We face an entirely different situation in the case of housing. Those who cannot afford alternative shelter will of necessity accept higher-density housing than they have been accustomed to in the past. The well-housed, however, who currently live in low-density environments and wish to preserve their traditional residential settings, will resist increased densities. Unfortunately, they represent the majority in most communities. As this trade-up market contracts, more developers will seek to build for the huge market of middle-income, first-time buyers who are increasingly being priced out of homeownership. To do this with today's construction costs, interest rates, and land costs will mean building smaller units at much higher densities. The affordable housing of the 1980s will be suburban condos and six-plexes.

On the other hand, liberalizing land-use and zoning controls may be of little help in relieving the shortage in built-up urban areas such as San Francisco where little vacant land exists to begin with. To increase the housing supply in the central cities is extremely difficult without attempting something along the lines of demolition, clearance, and rebuilding to higher densities. The displacement generated by such a strategy will only make the shortage worse. In these parts of the state, the answer lies in redeveloping industrial and commercial land for housing and promoting mixed uses incorporating housing. Most commercial districts were developed in this fashion prior to the introduction of zoning in the 1920s. This strategy, however, would require changes in zoning policy to allow residential development to compete effectively with commercial and industrial uses which ordinarily generate higher rents per square foot. This could be done by giving developers who include housing with commercial projects density bonuses, or by relaxing some of the physical design or off-street parking requirements of residential development in areas well-served by public transit.

Public Finance

We will also make little headway in expanding the supply of housing in California unless we can find some way to lower the cost of infrastructure and service provision for new development. I use the term "development" in the broadest sense of the word; not simply new subdivisions out in the fringes of suburbia but in-fill, rehabilitation, structural conversion, and redevelopment.

It is not true that in the Proposition 13 era new residential development "cannot pay its way." Some housing can—especially housing for the rich (and some housing cannot—primarily low-moderate income housing). In general, new housing is being assessed at a higher value than older housing and probably generates more revenue per square foot than older housing. Cities which are fiscal maximizers, however, will probably favor condo conversion over everything else, in the case of both residential and commercial uses. Assessed values double or triple as a result of condo conversion, with

almost no increase in the demand for public services or new infrastructure. The revenue gains from turnover thereafter are much greater than from the slower process of turnover in commercial or residential rental property. The real losers for local governments in the Proposition 13 era are properties which don't change hands often, particularly industrial property and long-term single-family houses. It would be helpful to extend conventional cost-revenue analysis, which has previously been used to determine the fiscal feasibility of new residential development, to all forms of existing real estate, including commercial property. The results might be surprising.

The financing of new infrastructure for residential development will prove expensive in the future. One way of at least keeping the costs down is to encourage city and county governments to stop forcing developers to bear the costs of these improvements. When developers put in new infrastructure, they include the cost in the selling price of the new homes they build. Homebuyers then finance these costs at conventional mortgage rates. An alternative approach would be to allow developers to create special assessment districts by which to finance the costs of public infrastructure in new subdivisions so that the prospective buyers can make use of tax-exempt municipal revenue bonds, the interest rates of which are generally anywhere from 250 to 350 basis points below those charged today on conventional mortgages. In many cases the savings could be as much as \$100-150 per month for the homebuyer.

It will be difficult to reverse the tax-cutting trend which has engulfed California and to evolve new ways of financing infrastructure unless we can articulate a positive concept of the role of state government in economic and social development. This will require a realistic evaluation of the benefits derived from government activities and their distribution across the population. Because the Proposition 13 movement has focused so intensely upon the issue of tax burdens irrespective of benefits, these considerations have been conveniently shunted aside by the simplistic assumption that government produces nothing other than bureaucrats who take two-hour lunch breaks and sit around

twiddling their thumbs the rest of the time. Until now, taxpayers have had the luxury of voting themselves tax cuts without having to suffer the pain of deciding which services should be cut as a result.

Nor have the taxpayers borne the responsibility for dealing with the impacts on housing of a shrinking public sector. For this reason, those who have a stake in expanding the supply of housing in California must ensure that consideration of housing impacts be included in all deliberations over tax and public finance issues. We can no longer afford to allow the debate over how to finance the public sector to continue in isolation from the question of how to solve the housing crisis.

This change in the debate over tax policy is more important than most people realize, for the fiscal crisis and the resulting dearth of public funds available for housing subsidies are leading to a major transformation in the instruments of housing policy and local levels, which may force a greater degree of market intervention than what we have been accustomed to.

Historically, government has used three instruments to reduce the cost of housing and encourage increased production: (1) direct subsidies, (2) indirect subsidies, and (3) direct public borrowing and lending. The first involves direct public expenditures to finance interest subsidies, land write-downs, capital grants, etc., or rent supplements. The second takes various forms, including homeowner income-tax deductions, loan guarantees, and mortgage insurance. The third instrument—the tax-exempt mortgage revenue bond—has come into great popularity recently and is widely used today by state and municipal housing finance agencies. Given the large size of the affordability gap,

especially in rental housing, tax-exempt financing provides only a shallow subsidy at a time when a much deeper subsidy is required.

While the widening of the affordability gap increases the need for subsidies, the capacity of government to provide them has diminished. As the political demand for social housing outstrips the growth of government revenues, housing policy is forced to rely increasingly upon forms of mandatory allocation and pricing such as rent control, inclusionary zoning, and credit allocation. This trend will grow because the tax revolt has tied the hands of government at the very moment that flexible tax and fiscal policies are needed to help relieve the production crisis in the housing sector. By 1985 not only will much of the rental housing stock in California be under some form of rent stabilization, but the volume of housing developed under inclusionary zoning ordinances and other forms of set-aside may exceed the existing stock of public housing.

III

The Chinese have a curse: "May you live in interesting times." The curse has fallen on us. Our world is changing very rapidly. To respond to those changes, we must proceed to restructure large parts of our economy and government. In the housing sector we can no longer rely on merely modifying and extending traditional policies. The current system of subsidies, especially in the rental sector, is simply not adequate to reduce the affordability gap. We must invent new ways of building and financing housing. If we are successful, we may turn the curse into a blessing.
