

## DOES CALIFORNIA HAVE A RATIONAL HOUSING POLICY?

Transcript of speech delivered by Tony Downs  
28<sup>th</sup> Annual Real Estate and Economics Symposium  
Sponsored by  
Fisher Center for Real Estate and Urban Economics, UC Berkeley  
November 17, 2005, St Francis Hotel, San Francisco

My topic today is: Does California have a rational housing policy? I will answer that question at the end of the speech. But my initial conclusion is: California does not have any single and coherent housing policy. California's de facto housing policies – insofar as they exist – are made by local governments, not by the state. So there is no comprehensive, coherent policy for all areas.

First let us examine a few facts about California housing. Most are well known to you.

California has the most expensive housing in the nation by a wide margin. In August of this year, the median price of single-family homes sold was \$568,890, which was 20.1% higher than one year earlier. Since 2000, the median price has risen 136%, or an average of 27% per year. The median home sold in the entire U.S. as of Sept. was \$212,000, up 13.4% over one year earlier. From 2000 to 2005, the U.S. median price rose 52.5%, an average of 10.5% per year – compared to the average of p; 27% per year in California.

This means California housing prices are 178% higher than in the entire U.S. – or 247% higher than in the rest of the U.S. excluding California, and rising almost three times as fast. But Californians' incomes are only 12% higher, and not rising much faster.

This situation has produced large numbers of both winners and losers regarding housing.

The 59% of California households who are homeowners – the second lowest fraction among all 50 states – are big winners financially. From 1999 to 2004, California home-owners gained almost as much gross equity wealth from rising home prices as all the homeowners in the entire other 49 states combined! Even after subtracting mortgage and home equity debt, California homeowners prospered mightily.

Yet Californians have the lowest housing quality standards in the nation. It takes young Californians much longer in their careers than any other Americans to amass enough money to buy or rent a home. And when they do, they get a smaller abode with fewer amenities than elsewhere per dollar spent, and it is farther away from where they work. So they commute greater distances and encounter worse traffic congestion.

A higher fraction of households here cannot afford to own a home than in other states, and overcrowding ratios are much higher here. In 2000, 24% of renters had over 1.0 persons per room, vs. 11% in the entire U.S. Yet foreign immigrants keep coming to this state because even its overcrowded and expensive housing seems better than what they had at home, especially because of better job opportunities here.

According to the 2000 Census, 2.86 million California households had 1999 incomes 80 percent of the statewide median or less – which makes them relatively low-income – and paid 30 percent or more of their incomes for housing. They were 1/4 of all state households. 71.2 percent were renters. Thus, in 1999, renters were a majority of California households experiencing an "economic squeeze" because of housing costs.

These data were before the recent California price rise of 135%. So the fraction of California households who are economically squeezed by high prices and rents is surely now much larger than 25% – closer to 1 out of 3.

Thus, the current housing situation in California is placing a severe economic squeeze on between 1/4 and 1/3 of all households in the state. This is not good.

In the 1990s, California experienced its first large-scale domestic out-migration of households. An average of 241,000 persons net per year left California for other U.S. states. Since 2000, the average has been 103,828. The state is trading mostly middle-class residents who are leaving for many more poor immigrants from abroad, so California's net population and poverty are both rising.

If you were running a global business trying to be competitive, why would you locate in California? It has the 10th highest state taxes per capita, by far the highest housing costs, a government that is broke, ranks almost last among states in spending per pupil on primary and secondary students in attendance, has an above-average poverty rate of 13.5%, has high cost of living expenses, and the nation's worst traffic congestion. Is California's good climate and pretty scenery really worth all that? In the long run, the high costs of living in this state will be a drag on its economic growth.

Now let me say a few words about why housing costs are so high in California. It is basically a combination of local government policies that discourage new homebuilding.

Local governments determine how many and what kinds of housing units can be built. Almost all suburban governments are politically dominated by homeowners, who comprise 70% of suburban voters, according to PPIC surveys. Homeowners are driven by two key goals: (1) maximizing or at least maintaining the values of their own homes, which are their major financial assets in most cases, and (2) preventing any worsening of traffic congestion in their areas. Traffic congestion worsens because of rising population and economic prosperity.

The first goal is served by not permitting any more lower-cost housing to be built nearby. The second goal is served by preventing as much growth as possible. To serve both goals, NIMBY homeowners pressure local governments not to allow much new housing to be built near them, especially relatively affordable – i.e., low cost – housing.

Housing production in California has fallen sharply from earlier when the total population was smaller. Total housing units granted permits averaged 204,000 per year from 1954 through 1989, but fell to 131,000 per year from 1990 through 2004. That is a drop of 36% in new units built each year, though average annual growth in population was about the same in both periods.

Local government obstacles to new housing construction, especially of low-cost units, have grown enormously since 1980, particularly along the coast. In the Bay Area, San Francisco devotes 31% of its land to housing. Hence its density is 16,000 persons per sq. mile.

The other 8 counties in the Bay Area contain 99.3% of its land, but devote only 12% to housing. So their overall density is 897 persons per square mile – 87% less than San Francisco's! Four counties have densities less than 500 persons per square mile!

The Bay Area is an extreme case, but it illustrates the basic reason why this state has high housing prices. California homeowners do not want enough new units to be built to reduce existing price levels; and homeowners control local governments. As long as local governments set the state's housing policies, there will be a permanent shortage of housing in California.

However, that does not mean California housing prices will rise forever; they will not. They fell in the 1990s, and they will level off or even fall in the next recession.

What government policies might change this basic housing situation?

Many say nothing needs to be done. People who live here must like it or they would move away. If they want cheaper housing, let them move to Nebraska or Nevada. Many poor households are illegal anyway and not entitled to public aids. And many immigrants come because conditions are a lot better here, so why should we feel sorry for them?

There are two basic ways to circumvent very high housing prices. One is to build enough additional housing to let the market drive prices down. That means opening up existing land to new construction and eliminating all the local regulations and red tape that make new construction so expensive. If enough new units were subsequently built, prices would decline.

This is similar to the apparent strategy of the State of California. The state wants localities to designate a lot of additional land on which housing could be built. This is undoubtedly a good idea if localities actually do it. Then, the state assumes, builders will create many new affordable units – enough more to cause lower prices. But this may be wishful thinking. Not enough new units would be built, and builders would not make them affordable in price, since they could get higher prices.

Just consider all the interests who don't want home prices to decline. They include the 59% of California households who are homeowners, all banks and lending institutions that hold mortgages on those homes, all the Realtors and home builders, all investors who own mortgage-backed securities and bonds, Fannie Mae, Freddie Mac, all local governments who don't want taxes to decline, all retail firms who depend upon consumer spending derived from home equity profits, and all the local officials these people support. These groups represent overwhelming political resistance to falling home prices. There is no chance whatever of getting locally elected officials to defy them. All local officials are parochial in outlook, acting primarily to benefit the local citizens who elect them. So they will not allow enough building to drive prices down.

In short, only a massive recession could produce anything like the adverse conditions that would cause a housing surplus big enough to reduce prices. And who wants to promote a recession for that reason, or at all?

The second approach to contend with high housing prices is providing subsidies to help people to pay for shelter. Because the gap between the incomes of low and moderate-income households and California's housing costs is so huge, those subsidies would have to be enormous. But what government is capable of doing this, let alone willing to do so?

The federal government is already running huge deficits sure to get worse because of greater social security and Medicare spending as baby boomers retire. And we are at war in Iraq. Also, the federal government has never paid its existing housing subsidies to all who are eligible. Getting new federal aid to pay for your high housing costs is politically impossible. It will never happen.

The California state government is broke, and no Governor or legislature will raise taxes. Getting the legislature to fund that huge housing cost gap is a non-starter.

Without being able either to build massive amounts of new housing or provide adequate public subsidies, how can California possibly help its 2 to 3 million low-income households squeezed by high housing costs? Most of them will have to continue to double and triple up, suffer from long commutes to lower-cost housing areas, and live in very small quarters that take up large share of their incomes.

Does that mean that nothing can be done? No – I believe some action can be taken to start moving towards providing at least some affordable housing units for low-income residents.

That something is mandatory statewide inclusionary zoning. Over 100 of California's 450 local and county governments have already adopted inclusionary zoning. As best I can determine, those communities are producing about 3,500 affordable housing units each year. But rising prices have recently been placing an additional 300,000 existing housing units out of reach of low-income households each year too – so those households are losing ground.

Inclusionary zoning is not now very effective overall because it is mostly voluntary, and most communities don't adopt it. Also, since every city that adopts it has different rules – often ineffective ones – it does not produce a large number of affordable units. But if it were mandatory on all builders throughout the state, and had the same basic rules everywhere, inclusionary zoning could produce many times more affordable units that are now being built throughout California.

If inclusionary zoning were made mandatory statewide for all homebuilding over 5 units, and set at 20 percent of output, then if homebuilders created 120,000 new units a year – the actual average from 1990-2002 – they would supply 24,000 affordable units per year. If builders created 200,000 units per year, as is likely this year, then 40,000 would be affordable. That is small compared to the millions of units low-income households need. But it beats nothing, and it will grow over time at 240,000 to 400,000 units per decade.

Most homebuilders don't like inclusionary zoning. They believe it is a way for the state government to put most of the costs of housing poor and working class households on the backs of homebuilders and landowners, rather than taxpayers. And they are right.

So the only way to make it fair to homebuilders is to provide them with offsetting incentives. Those include density bonuses, reductions in development fees, changes in zoning rules, accelerated processing for affordable projects, and exemptions in localities that already have a lot of affordable housing units. And the affordable units builders create don't have to be as big or as fancy as the market-priced units the builders are creating at the same time. But they ought to have compatible exterior designs to they can be integrated into surrounding neighborhoods.

Another possibility is charging non-residential builders fees based on the jobs that will be located in the structures they build, called "linkage fees." The cities of Sacramento and San Francisco do this. New Jersey is going to do it statewide. If California adopted a similar statewide charge, it could reduce the share of affordable housing builders would have to provide to below 20%. The details of such a program need to be worked out by more extensive studies than I can do.

Mandatory statewide inclusionary zoning has three major drawbacks.

First, it loads much of the costs of achieving a public goal – reducing housing prices – on specific private groups such as homebuilders and landowners. But those groups have been getting wealthy because of the rising prices that have created a tremendous price squeeze on probably 3 million California households. So I think inclusionary zoning should be done in this quasi-emergency, even though it is not a perfect policy.

The second drawback is that inclusionary zoning cannot produce enough low-cost units to meet all the needs to relieve the economic squeeze on California's low- and moderate-income households. But it will produce a lot more than are being built now.

Third, inclusionary zoning requires a means of following up the occupancy of affordable units over time so they don't just provide windfall profits to initial owners or renters. That is complicated and requires public funds, but it can work.

But mandatory inclusionary zoning has two huge advantages: (1) It would actually produce significant numbers of housing units affordable to low-and-moderate income households, to teachers and police and firemen, and to thousands of Californians now being economically squeezed by ever-rising home prices and rents. (2) It would not generate huge public costs.

**NO OTHER POLICY ANYONE HAS SERIOUSLY SUGGESTED WOULD DO THESE THINGS.** Other policies I have heard assume fairy-tale behavior by local governments and home builders – behavior that has never happened. Therefore, those who reject my policy recommendation have an obligation to suggest a better one.

So the public policy choices are clear: Do nothing effective to help the millions of low-income households who are suffering more each day because of rising home prices that make the majority of Californians richer. Or start a small-scale but realistic program of building a modest number of affordable units as a proof of public concern for those citizens being squeezed. Gradually, that program would provide more and more affordable units for more and more low-income households, thus enabling them to partake of the American dream.

In conclusion, I believe mandatory statewide inclusionary zoning is the only rational housing policy that the State of California could actually achieve. Doing so would require the state government to force local governments to stop preventing needed new housing construction by shifting some power over housing decisions to the state level.

That means changing the total reliance on home rule to control housing that Californians and other Americans have long supported. But local governments are far too parochial. State governments must assume a bigger role. After all, the moral responsibility of the state government is the welfare of all its residents, not just the wealthiest or homeowners.

If the state government does not adopt this strategy I have recommended, it will simply stand by while local governments continue their presently restrictive housing policy.

That present housing policy is: Continue to block enough new home construction, both ownership and rental, so housing prices keep rising and enriching homeowners and homebuilders. Too bad that this policy economically squeezes the 41% of the population that cannot afford housing here. After all, they happen to be at the low end of the income distribution, and many don't even vote. So we can ignore them, even though they provide many services essential to the state's economic future. Let them fend for themselves.

As a sometime California resident, and an American, I do not believe that present policy is worthy of this great state. Therefore, I hope you will think seriously about the alternative I have described. Inclusionary zoning is not perfect, but it would be a lot better than nothing at all, and especially better than the present restrictive housing policy. Thank you.