Meeting the Challenge of California's Housing Supply and Affordability Crisis

A Proposal to Consider a Dedicated and Permanent
Source of State Funding for
Affordable, Workforce Housing in California

A Call to Action to California's Economic and Business Leadership

DRAFT

For Review at the Civic Entrepreneur Summit – 2005

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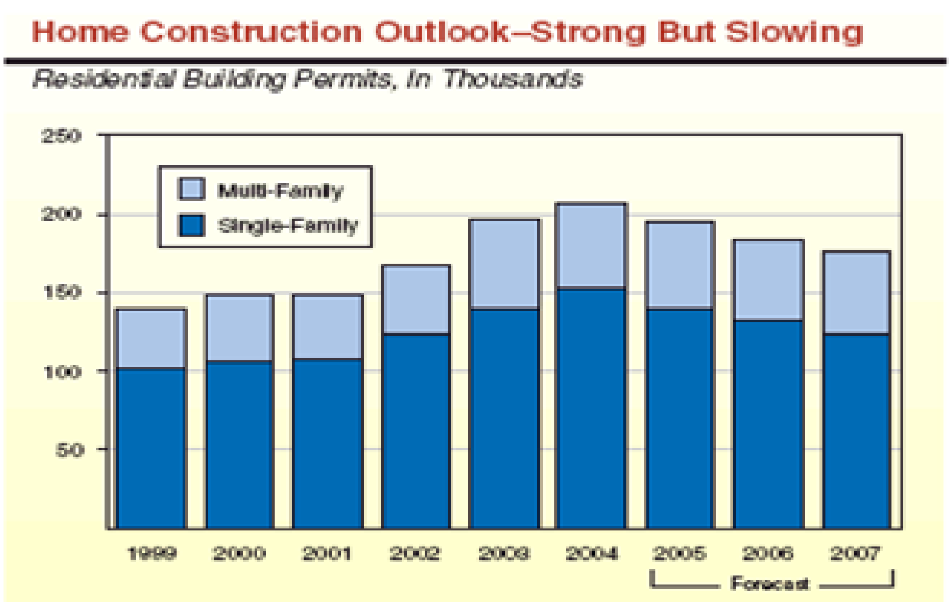
Executive Summary

California is currently in the midst of a housing crisis in two parts. The first part is an under-supply of newly built housing needed to meet California's continuing population growth. This crisis is the most serious driver of the second part, housing affordability. The fewer houses that are built, the fiercer the competition and the higher the price. It's simply the law of supply and demand.

Because of supply shortages, rapidly rising housing prices and rapidly falling affordability, California's housing crisis has reached the crisis stage, especially in the state's largest metropolitan areas, but truly all over the state. Population growth has outstripped new housing production for over two decades. New housing production declined in California from 2.1 million units in the 1980's to 1.1 million units in the 1990s, even as population surged (PPIC, 2005).

Home construction finally exceeded 200,000 units in 2004, the strongest level in 15 years. For those at the lowest income levels, which cannot be reached by the market sector, many new homeownership and rental units were subsidized by the state's affordable housing subsidy program, Proposition 46 bond funds. But the state's independent Legislative Analyst's Office (LAO) forecasts that new construction will start to retreat modestly from 2004 levels. The LAO projects that permits for new construction will fall below 200,000 in 2005, and slide to a range of 180,000-to-190,000 for the remainder of the forecast period. See Figure One. Its forecast assumes that interest rates will increase only modestly, that Prop 46 funds will run out, and that underlying population and income growth will result in continued strong demand for new housing in California.

FIGURE ONE



This paper outlines the current affordable housing crisis in California and its impact on families and the economy; documents the positive impact the housing industry has on the California economy; outlines a broad array of policy ideas currently under consideration that could help increase the supply and reduce housing production costs (and the price to the consumer); makes an economic case for the need to find a new source of state subsidy for affordable housing - because Prop 46 bond funds will be exhausted by early 2007; explores options for a permanent, dedicated source of revenue for the state subsidy; and *calls for broad and intense dialogue, particularly within the mainstream business sector*, to find a consensus approach to solving this crisis. California's economy and quality of life will suffer, perhaps irreversibly, if the state government doesn't take action in the near future.

The Economic and Family Impact of the Housing Supply and Affordability Crisis in California

California's housing affordability levels are plummeting. California's low and still declining affordability rates hurts families by forcing them to pay higher and higher percentages of their income on housing; and by driving buyers, particularly first-time buyers, to the metropolitan edges, often with long commutes and traffic congestion. The unavailability of affordable housing diminishes California's economic competitiveness by reducing the ability of the state's businesses to attract and retain key workforce talent. The unaffordability of housing drives up wages and makes California's businesses uncompetitive with other regions across the country and world.

As shown in Figure Two, in May 2005 only 16% of California households could afford to purchase a median-priced home, as compared to 50% of households nationally. *This level, 16%, is down from 21% just in 2004 and 34% in 2001*. As a result, California's homeownership rate of 58.9% is the third lowest in the nation, behind only New York and Hawaii, and is 10% lower than the national homeownership rate of 68.3%.

FIGURE TWO

Percentage of Families That Can Afford to Purchase a Home

	May 2005	April 2005	March 2005		April 2005	
California	16	17	18		20	
California – Condos		24	25		31	
United States	50	50	54	r	57	r
C.A.R. REGION						
Central Valley		20	21		32	
High Desert		34	36		52	
Los Angeles		16	17		20	
Monterey Region		10	10		12	
Northern California		15	17		24	
Northern Wine Country		8	9		14	
Orange County		11	11		13	
Palm Springs/Lower Desert		11	n.a.		13	
Riverside/San Bernardino		20	21	r	28	r
Sacramento		21	23		33	
San Diego		10	10		14	
San Francisco Bay Area		12	12		17	
San Luis Obispo		11	13		20	
Santa Barbara County		10	9		13	
Santa Clara		18	19		24	
Ventura		13	14	r	17	
COUNTY						
Alameda		11	12	r	18	
Contra Costa		10	10		11	
Fresno		24	24		34	
Marin		12	11		16	
Merced		16	16		30	
Riverside		19	19	r	22	r
San Bernardino		24	23	r	35	r
San Francisco		8	9		12	
San Joaquin		14	15		28	
San Mateo		10	11		17	
Santa Cruz		12	12		15	
Sonoma		8	9		15	
Stanislaus		19	21		35	

r – revised Source: California Association of REALTORS®
California Association of Realtors Housing Affordability Index 1
Percentage of households that can afford to purchase a median-priced home based on an average effective mortgage interest rate of 5.81 percent, assuming a 20 percent down payment and 30% of income going towards housing:

The Impact on Families. Frozen out of the housing market, individuals and families are taking the only option that is available to them to find affordable housing, choosing long commutes and some are just leaving the state altogether. Ironically, this crisis continues to occur at a time when, because of historically low interest rates and resulting low mortgage rates, first-time buyers traditionally should benefit from increased affordability. Obviously, this is not the case now. And the LAO and other California economists forecast a higher interest rate environment in the upcoming years. For prospective buyers, these higher projected rates will further reduce the affordability of new homes and freeze more families out of the housing market.

The impact is ubiquitous. As shown in Figure Two above, the housing supply and affordability crisis is not limited to "hot markets." It is felt in virtually every neighborhood, city and region in the state. Regions once considered "affordable," even though often requiring long commutes to job centers, are becoming less so. Moreover, the influx of commuters to many regions is driving up home prices for existing residents. *The California Association of Realtors chart above shows that only 20% of households in the Central Valley can afford a median-priced home, down from 32% just a year ago*. This is a crisis across the state, and not just in the coastal regions.

The poor and the "working poor" feel it the most. This downward trend in affordability and homeownership has especially critical implications for families who can only enter the housing market through public subsidies for home purchase or multifamily rental construction. As we under-produce the general supply of housing and overall affordability drops as a result, the demand for housing, including among the poor and near-poor, doesn't diminish. The under-supply (and unmet demand) results in increased production costs, particularly in the competition for land. Whereas the market adjusts and many people of modest or higher incomes have figured out ways to afford higher- and higher-priced housing, the housing built for low and very-low income households is supported by relatively fixed amounts of public subsidy. Thus, the "reach" of that subsidy covers fewer and fewer units, serving fewer families. This increases the amount of over-crowding in California housing (more families living in fewer households).

The Impact on Business and the Economy. California's tight housing supply and low affordability levels are increasingly a threat to the state's economy. Unless addressed, the crisis threatens to depress construction activity -- and construction employment – and thereby reduce general economic activity, with negative consequences that will "ripple" through most other sectors of the economy, including government tax receipts.

> Building and rehabilitating more affordable housing not only meets a demonstrated need, but it has economic benefits in both the long and short term. Housing creates jobs and wages, creates a greater demand for goods and services, increases tax revenues, and attracts funding sources to local and state jurisdictions. In addition, providing people with stable and decent housing will likely reduce the amount of public funding they might otherwise use.[2]

In its 2003 report, "Principles and Policies of California Homebuilders," the California Building Industry Association said (the numbers are higher today): "If California was building the housing it needs, home construction would be generating $70 billion to the state's economy, creating nearly 630,000 jobs and sending $4.4 billion a year to the state's treasury – ever year."

Moreover, business leaders and economic development experts believe that the crisis makes it increasingly difficult to attract and retain a high quality workforce and therefore threatens the long-term economic vitality of the state. Successful, sustainable economies require a diverse

[2] The National Housing Trust Fund Campaign website, www.nhtf.org

workforce, and workers require affordable homes that meet their family's needs and that are close to jobs and/or transit and transportation corridors -- that enable a reasonable commute. Private sector investment and public policies must support an adequate supply of affordable housing for all Californians – wealthy, working, and poor – if we're to have the diverse, productive workforce that is the key to securing our economic future.

The Future: Projected Population Growth Will Drive Housing Demand in California.
The state's population is projected to grow at an average annual rate of about 1.6 percent a year, and 12 million over the next 20 years. In absolute terms, the number of new Californians added each year— nearly 600,000 people—exceeds the size of such cities as Long Beach, Fresno, and Sacramento. California's population growth consists of two major components—natural increase (the excess of births over deaths) and net in-migration (persons moving into California from other states and countries, minus people leaving the state for other destinations). The LAO projects that the natural-increase component will average more than 300,000 new Californians annually over the forecast period. This net natural gain reflects an annual average of around 550,000 births partially offset by about 250,000 deaths. Net-in-migration adds nearly another 300,000 people each year, and generally is only slowed by deep recession, not an option anyone wants to promote. These demographic trends suggest that the housing supply and affordability issue will remain at the top of the state's priorities well beyond 2025, and therefore we will either solve the current supply and affordability crisis, or it will get worse. We cannot sustain the status quo.

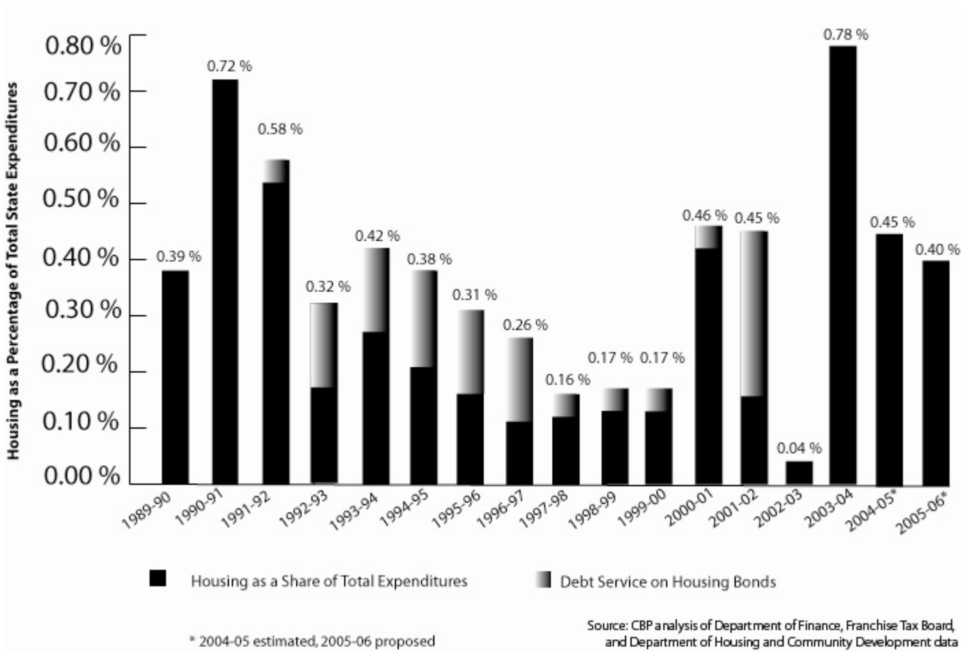
What is being done? Unfortunately, the public policy tools that private and nonprofit developers, builders, planners, and local elected officials possess to deal effectively with this crisis are piecemeal, ad hoc, and so far, insufficient. As documented in this report, various policy discussions are underway in Sacramento to address the problem of under-supply and a major cause: the excessive cost of housing related to regulations, fees and housing approval processes. With respect to subsidized housing for low- and very-low income families, the establishment of local and regional housing trust funds has partially addressed the problem, and they are an efficient mechanism for delivering subsidy funds. But controversy and uncertainty over their revenue sources make them problematic. The need for a statewide solution remains and leadership from state government is essential. State Proposition 46 bond funds, as detailed below, have provided significant help. But these funds are running out and the current scope of the housing affordability problem demands immediate and long-term solutions at all levels of California government.

Note: Housing Trust Funds are commonly defined as distinct funds established by cities, counties and states that permanently dedicate a source of public revenue to support the production and preservation of affordable housing, including development, mortgage assistance, rental support, and rehabilitation. As used in this report, the term "Housing Trust Funds" is not synonymous with a permanent, dedicated source of funding, but rather represents an example of an effective funds delivery mechanism.

The History and Recent Record of State Support of Affordable, Workforce Housing

Over most of the last two decades, California has gone from being a leader of innovative state housing policy to a laggard. During the late 1980s, California implemented a series of innovative housing programs and provided substantial funding for its housing efforts, with General Fund appropriations to a number of housing special funds as the main source of funding. Among the state's signature initiatives were creation of the first state housing trust fund in 1985; creation of a state supplement to the federal low income housing tax credit in 1987, and passage of three affordable housing bonds in 1988 and 1990 totaling $600 million. The 1990's, in part because of the state's severe fiscal crisis early in the decade, saw a "drought" in new state innovations and support for affordable, workforce housing. State housing spending dropped substantially during 1990s from 0.7 percent of total spending in 1990-91 to 0.2 percent of total spending in 1999-00. As these funds disappeared only minimal state support was allocated to take their place. Before Proposition 46, the absolute number of dollars allocated to housing and related programs had shrunk to less than half that of the decade before.

FIGURE THREE



Proposition 46

In 2002 the voters passed Proposition 46 with a 57.6% majority. Prop 46 provided $2.1 billion in state bond funds, the largest such measure in the nation's history. This measure has been vital in supporting affordable housing in California over the past three years.

According to PolicyLink and Housing California, when fully expended, Prop 46 funds will help more than 42,000 families achieving homeownership; leverage the construction of more than 41,000 new affordable rental units; and produce more than 24,000 additional emergency shelter beds. The additional construction and mortgage dollars infused into the economy as a result will add approximately 276,000 California jobs and leverage $10.6 billion of new private and federal investments in the state.[3] In the Bay Area alone, $201 million in Proposition 46

[3] Policy Link, *Housing California*, *Executive Summary*, Winter 2005.

funding to date has attracted $700 million in private capital, federal funding, and local matching funds.

But Proposition 46 funds are due to run out in early 2007.

Annual appropriations and bond financing have helped thus far, but is this the best policy, and politically feasible? Affordable and workforce housing has been funded by state government over the years either (rarely) through annual appropriations or (more often) through General Obligation bond funding -- rather than a permanent, dedicated "pay-as-you-go" strategy, as is used by 28 other states. This approach has four major drawbacks. First, bonds are more costly than pay-as-you-go financing—roughly one-third more costly on an inflation-adjusted basis according to the LAO. Second, bonds are less reliable and predictable (in that their use depends on voter approval) than pay-as-you-go funding. The availability of funds is dependent on a wide variety of forces beyond the control of housing officials and advocates (the competition for the use of the General Obligation bond with other worthy uses: schools, transportation, water and parks projects, etc.).

Third, the high variability in funding – small peaks followed by deep valleys – hampers planning and efficient use of tax dollars for a problem that is growing persistently and predictably, as California's population grows every year. This is problematic in an industry in which the typical length of the planning and zoning approval process requires long-term thinking and planning, by local governments and builders alike. Finally, relying on another General Obligation bond such as Prop 46 or General Fund dollars could divert resources from already strained future budgets, as borrowing eventually becomes a drag on future budgets, and as revenues are diverted from current programs to pay for past borrowing. Budgetary borrowing already undertaken in 2004 and prior years will result in annual General Fund costs of nearly $4 billion for the 2006-07 through 2008-09 fiscal period. Servicing this debt load inevitably reduces the General Funds needed in the future for K-12 and higher education, social and health programs, and other critical needs that compete for annual General Fund appropriations.

The Current Opportunity (and Necessity) to Meet this Challenge

> "The state must figure out a way to finance affordable housing and offer subsidies to developers to assist with that. I agree that it is not fair to expect the development community to do it all by themselves – the state needs to offer some assistance. Prop 46 funds will be running out soon…We need to find a permanent source of funds to assist with affordable housing."
>
> Assemblymember Gene Mullin
> Chair, Assembly Committee on Housing and Community Development

Over the course of the past three years Proposition 46 programs made a significant contribution to addressing the state's housing crisis. But, Proposition 46 funds will be exhausted by early 2007 and enacting another General Obligation housing bond on a 2006 ballot is seen by many political observers as potentially problematic. It may be that a new General Obligation bond is the most feasible approach, but for the reasons stated above, this report suggests that we consider another option, the establishment of a permanent, dedicated source of funding for state subsidy of affordable housing.

If California is serious about successfully addressing the key issue of workforce and affordable housing in a sustained, long-term manner, it is time to consider new, innovative, and sustainable funding strategies that offer predictable, dedicated, and reliable streams of funding to help meet the state's long-term need. As the housing crisis in California is not a temporary problem, but an issue likely to be with the state for decades, it is now time to consider establishing a permanent source of funding. The upswing in the state's economy, coupled with growing support for solutions to the housing crisis, makes this an ideal time to explore innovative state-level solutions.

In this report we present:

i. The Dimensions of the California Housing Crisis
ii. The Direct Economic and Social Benefits of – and the Economic Necessity for – a Robust Housing Industry
iii. Possible Future Solutions, with a Permanent, Dedicated State Subsidy only a Piece of the Puzzle
iv. The Policy Options for Continued State Subsidy for Affordable Housing – What is the Best Policy and What are the Prospects for Political/Policy Success?
v. The Case for Considering a Permanent, Dedicated State Subsidy
vi. Potential Revenue Sources for a Permanent, Dedicated State Subsidy – with an Economic Analysis
vii. The Policy and Political Feasibility of Adopting such a Subsidy – the role of the Business Sector in Making the Case – A Call to Action

Of one thing we are certain, California should not be left without a source of state subsidy for affordable housing -- as Proposition 46 funds run out. California's economy and families should not be dealt such a blow.

In its most recent biennial report, the California Economic Strategy Panel, the "voice of the economy" inside state government, addressed the importance of the issue from an economic perspective:

> "There is enough capital and demand, and we know what the issues are – that is not the problem. Leadership at the state and local level is needed to address the "housing crisis" – we need to create a more supportive political norm."
>
> "*Creating a Shared California Economic Strategy*" 2002

We intend to give this Report broad distribution and to help organize policy discussions at the regional and statewide level to determine whether any of the potential revenue sources, or a combination thereof, might draw the broad constituency and policymaker support necessary for legislative and/or voter approval.