



UCLA AFFORDABLE HOUSING POLICY BRIEF

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The UCLA Ziman Center for Real Estate presents the next in a series of Affordable Housing Policy Briefs. This February 2020 Brief outlines the primary factors driving the rise of housing costs to crisis levels in California. On January 23, 2020, the brief's author, UCLA Anderson School of Management Professor of Finance and Arden Realty Chair Stuart A. Gabriel, recently presented these factors as Invited Testimony to California's Little Hoover Commission, California State Capitol.

Costs of the Housing Crisis

The factors behind California's high-priced homes, and some possible remedies

By [Stuart A. Gabriel](#)

House prices in major coastal areas of California fell by roughly 40 percent between 2007 - 2012 in the wake of the global housing and financial crisis. Since that time, quality-adjusted house prices in California have more than doubled from their crisis-low and currently stand at roughly 10 - 30 percent in excess of their 2007 pre-crisis peak.¹ Severe affordability problems have emerged in the wake of the related house price run-up. In California, some 17 percent of homeowners and 30 percent of renters face severe affordability burdens, paying over half of their household income for housing.²

The strong rebound in California house prices reflects a myriad of factors pertaining to both housing supply and demand. In recent years, housing production in the state (including both single- and multifamily units)

¹ See Case-Shiller House Price Repeat Sales Indices for San Francisco and Los Angeles.

² Harvard Joint Center on Housing Studies, State of the Nation Housing Report

has been damped at roughly 110,000 units annually on average, about one-third the 1986 level. The most recent production level is triple the average pace of the 2008-2014 post-recession period, when production in the state averaged a mere 46,000 units per year.³ In the wake of both depressed production and ongoing household growth, a substantial deficit in California housing has accrued. Since 2005, California has produced only 30 housing units for each 100 new residents.⁴ In response to the housing shortfall and related affordability crisis, Governor Newsom has called for the production of 3.5 million new housing units through 2025. In marked contrast, the UCLA Anderson Forecast predicts issuance of a total of only 125,000 new housing permits (including both single-family and multifamily) each year for the next few years. The UCLA Anderson Forecast thus suggests that homebuilding in California will fall far short of the Governor's goal.

“Rising costs and constraints on affordability are associated with higher levels of metropolitan congestion, out-migration of households and firms, limitations on job growth, and reductions in metropolitan economic base and activity. Further, the high costs of housing, particularly in major California cities, have contributed to the sharp rise in homelessness in those areas. Hence sharply rising housing costs imperil households as well as substantially adversely affect the California job creation and economic competitiveness.”

BACKGROUND

The price of a home can be viewed as the sum of land costs plus the value of improvements on that parcel of land. An equivalent dwelling can be priced very differently depending on whether it is in a coastal metro area or in the Sacramento Valley. Equivalently, housing costs can be divided into their primary inputs of land, labor, and capital. In that case, labor and capital are reflected in the value of improvements. In general, of the three production inputs of land, labor, and capital, the ongoing and marked upward movement in California house prices over time owes most importantly to substantial increases in land costs. Indeed, locational, environmental, public finance and safety, local government zoning and regulatory, and other location-specific amenities are capitalized into the price of land. In many cases, the valuations associated with location-specific amenities—such as access of employment, school quality, neighborhood safety, or air quality--have trended up markedly over time. Further, land costs are differentially higher along the coast relative to inland areas. In coastal metro areas, locational attributes including beach proximity, temperate climate, access to diverse urban amenities and employment centers, and the like all make for land costs that have and will remain elevated relative to less in-demand valley areas. Statistical methods can be used to extract the value of specific locational amenities from aggregate property values.

It is the intersection of supply and demand-side factors that determine house prices. Demand for housing varies with local demographic and economic factors, including net migration, household formation, local incomes, wealth, and employment, and demand for localized amenities including school quality, access to transit and jobs, environmental amenities, and the like. A fundamental tenet of housing economics is that all households require a housing unit.⁵ California has seen marked growth in number of households over the past 40 years. In the wake of the passage of Proposition 13, California's population grew from roughly 23 million persons in 1980 to 40 million in 2020. Population growth reflects natural net population increase plus net migration. While birth rates in the state have moderated and out-migration of less-educated and lower-income households continues, the state has recorded substantial ongoing international and domestic in-migration. As discussed above, the population growth continues even as the state has seen markedly reduced increments to housing supply. The combination of these fundamentals has pushed up prices and reduced affordability, particularly areas of the California coast characterized by strong demand-side pressures in the context of binding geographic and land-use regulatory supply constraint.

³ www.cirbreport.org

⁴ Governor Gavin Newsom, October 20 2017

⁵ This equating of households and housing units in California doesn't quite hold owing to over-crowding and doubling up of households in a single housing unit as well as large numbers of homeless households who are without housing.

FACTORS RELATED TO CONSTRAINED HOUSING SUPPLY IN CALIFORNIA

I. LOCAL GROWTH MANAGEMENT

A salient factor associated with rising land costs in California is local government regulatory constraint on supply of land for development. Supply of new land for residential development in California has been adversely affected over the period of the past 50 years by local government fiscal and exclusionary zoning, whereby zoning and entitlement tools have been utilized to markedly constrain the type and pace of development within local jurisdictions. In the academic literature, we use the term fiscal zoning to describe local land-use allocations based on the municipal cost-revenue impact. In general, jurisdictions may seek to minimize allocation of land to uses for which the fiscal impact is negative; in those cases, local property tax and other revenues associated with development fail to cover the costs of local public service provision, including costs associated with schools, public safety and infrastructure. Exclusionary zoning typically refers to municipal efforts to exclude low-income groups who may require additional public services or otherwise be unwelcome in more homogenous and higher-income jurisdictions. What started as local exclusionary and fiscal zoning practices ultimately gave rise to formal growth management practices. In the first voter-approved growth management initiative in California, voters in the City of Petaluma — some 40 miles north San Francisco — in 1972 capped approval of new homes at 500 units per year, or about half the previous year's total. In landmark action in 1976, the California Supreme Court declined to review an appellate court ruling that upheld Petaluma's growth limits.⁶ Petaluma thus became the poster child of local growth management both in California and beyond. With local variation, Petaluma's approach was soon replicated by a large number of California jurisdictions—particularly those in major coastal areas where demand-side pressures were strong. Hence, in the wake of perceived adverse fiscal, environmental, neighborhood or other impacts, California localities became innovators in constraining supply of land to new residential development. Owing in part to local regulatory constraint on supply of land for development, land costs have risen markedly in localities characterized by strong demand-side pressures. It is estimated that land costs comprise roughly 26 percent of the cost of building a home in California. However, given locational variance in the cost of land, a new home in Santa Monica could be 6 or more times the price of an equivalent home in the Inland Empire, owing to similar variation in the price of land.

II. PROPOSITION 13 AND THE RISE OF LOCAL DEVELOPMENT FEES AND EXACTIONS

A second important factor associated with constraint on supply of land for development—especially for development of affordable rental units—was the 1978 State of California property tax limitation known as Proposition 13. Proponents of the initiative argued that the roughly 50 percent average reduction in property tax rates imposed by the limitation—to about 1 percent of market value—would make housing more affordable to residents of California. Unfortunately, proponents of the initiative failed to consider local government response to this halving of their primary revenue source. In the 1970s, property taxes were the primary funding source for local public education. The reaction of local government to revenue cuts associated with Proposition 13 included (1) the increased application of growth management tools to reduce, deny or delay development of those real estate asset classes with a negative fiscal impact, notably including low-income and affordable housing; (2) imposition of elevated fees and exactions on new construction so as to help recoup lost property tax revenues necessary for local public services; and (3) competitive efforts to attract retail development in place of residential development as those properties yielded alternative sales tax revenue.⁷

Now, those elevated development fees and exactions have become an important local government revenue source. For example, local fees and exactions on a newly built 2,000 square foot single-family home in Elk Grove – a middle-income bedroom suburb south of Sacramento – can currently sum to \$80,000 or a full 20 percent of the \$400,000 sales price of typical new home. Further, those fees and exactions rise markedly

⁶ Builders had argued unsuccessfully that the growth restrictions were an unconstitutional infringement on people's right to travel and live where they want.

⁷ Gabriel, Stuart, Katz, and Wolch, "Local Land Use Regulation and Proposition 13: Findings of a Recent Survey" <https://escholarship.org/uc/item/12r370cj>, 1980.

as one gets closer to California coastal metropolitan areas. For example, in San Jose, local development fees and exactions may be two-fold the \$80,000 per home level currently imposed by Elk Grove. Compare that to the roughly \$12,000-\$20,000 cost of impact fees on a new \$400,000 home in such places as Austin, Las Vegas, or Phoenix. As such, local development fees add substantially to the price of a new California home so as to markedly reduce affordability. The marked hike in development fees and exactions associated with Proposition 13 reflected an effort to shift the costs of local public service provision to new residents of a community. In many cases, those fees go beyond the cost of stated service provision so as to simply provide an additional source of general fund revenues. Such a practice potentially creates serious tax inequities between newcomers and existing residents of a community. In the end, Proposition 13 served to substantially reduce mobility among long-standing single-family homeowners as well as increase the cost of housing to new buyers in California.

III. CONSTRUCTION EMPLOYMENT AND COSTS

A third factor currently adversely affecting construction costs pertains to the availability of skilled construction labor. Bear in mind that timber framing remains the dominant residential building technology and accounts for the vast majority of new housing construction. Current homebuilding technology is labor-intensive and involves employment of distinct homebuilding trades. Construction employment is currently running at about 900,000 persons, near the employment peak of 2006. Further, per the UCLA Anderson Forecast, we are currently at full employment of construction workers. Also, multi-family construction requires higher skill levels than single-family development. The lack of construction worker supply is associated with higher production costs and delayed delivery of new homes. Overall, construction costs inclusive of labor and capital costs have increased in recent years at a rate of 5-6 percent or roughly double that of inflation.⁸ Those direct construction costs are estimated to comprise 28 percent of the costs of developing a new California home.

SUMMARY OF HOUSING CONSTRUCTION COSTS

In summary, across areas and on average, the costs of building a home in California can be roughly allocated as follows:

20%	government fees and exactions
28%	direct construction costs
26%	land costs and development

Local government land-use regulation, including constraint on supply of land for development and imposition of elevated development fees and exactions, have exacerbated limitations on land supply and resulted in ongoing increases in land and development costs. Among remaining costs, some 20 percent reflects general builder administration and sales costs. Builder pre-tax profit margins may be in the neighborhood of 6 percent.

APPROACHES TO REDUCTION IN HOUSING COSTS

There exist potential remedies and related approaches to mitigation of high housing costs as described above.

I. LAND COSTS

Land costs comprise roughly one-quarter of development costs and have a wide spatial variation. The wide spatial variability in land costs suggests a potential approach to problems of housing affordability. Improvements in transportation access to lower cost areas would unlock substantial demand for those sites and result in measurable private sector production response. Improved rapid transit infrastructure to and from outlying and more affordable areas would facilitate job creation in those areas as well as enable commutes from those areas to metropolitan job centers. For example, substantial developable land is

⁸ See Turner Building Cost Index

available in the Palmdale and Lancaster areas north of Los Angeles. Limitations in road networks and long commutes currently constrain demand for and related development of those sites. Public investment in transit and related infrastructure could substantially reduce commute times and facilitate the development viability of those areas. Hence transportation infrastructure investment can and should be viewed as an instrument of affordable housing development policy and an effective scalable means of addressing high housing costs. In contrast, it is unlikely that we will see measurable private production of affordable housing in high-cost coastal areas, such as Santa Monica. It is often infeasible and typically not profit-maximizing for private developers to put unsubsidized low-rent housing on expensive land.

II. GOVERNMENT FEES AND EXACTIONS

The elevated development fees of many California localities serve to substantially raise housing costs, reduce affordability, and often involve subsidy by new residents of local public service provision to existing residents. From a public finance perspective, alternative revenue tools should be employed that provide for tax progressivity, whereby higher income residents pay more for services than lower income residents. Similarly, efforts should be undertaken to achieve horizontal equity, whereby similar income residents pay the same tax. Elevated development fees and exactions and Proposition 13 more generally may violate principles of horizontal equity, as similar income taxpayers residing side-by-side in largely equivalent dwellings often pay very different fees and property tax. Finally, rather than using development fees and exactions to fund general spending by local government, jurisdictions should be required to link development fees to the actual costs of services provided.

III. DIRECT CONSTRUCTION COSTS

Per above, the state should encourage building technology innovation consistent with more efficient and lower-cost construction methodologies.

CONSEQUENCES OF RISING PRICES AND DAMPED HOUSING AFFORDABILITY

Rising house prices and related marked declines in affordability have adverse consequences both for affected households and for metro areas more generally. Substantial literature suggests a negative association between affordability constraints and household well-being, including quantity and quality of housing consumed (residential overcrowding), longer commutes, and reduced spending on other goods and services including health care, child well-being and education. At the metro level, rising housing costs and constraints on housing affordability are associated with higher levels of metropolitan congestion, out-migration of households and firms, limitations on job growth, and reductions in metropolitan economic base and activity. Further, the high costs of housing provision, particularly in major California cities, have contributed to the sharp rise in homelessness in those areas. Hence sharply rising housing costs imperil households as well as substantially adversely affect the California job creation and economic competitiveness.